REPORT #901

TAX SECTION

New York State Bar Association

COMMENTS ON H.R. 846

May 21, 1997

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TAX SECTION

New York State Bar Association

May 21, 1997

The Honorable Barbara B. Kennelly
United States House of Representatives
House Ways & Means Committee
201 Canon Building
Washington, D.C. 20515

Dear Congresswoman Kennelly:

Enclosed please find a report of the New York State Bar Association Tax Section, which discusses the "constructive sale" provisions and the amendment to Section 351 set out in H.R, 846 ("the Bill"). The principal authors of the discussion of the constructive sale provision are David M. Schizer and Samuel J. Dimon. The principal author of the discussion of the amendment to Section 351 is Andrew N. Berg.

This report supplements the one we issued on March 1, 1996, commenting on the constructive sale proposal issued by the Department of the Treasury in January 1996 ("the Treasury Proposal"). We now comment on differences between the Bill's approach and that of the Treasury Proposal, as well as on the Bill's proposed effective date for the constructive sale legislation.

The report discusses the Bill's exemption of certain short-term hedging transactions from treatment as constructive sales (the "Safe Harbor") and recommends against inclusion of the Safe Harbor. We believe that a hedge with constructive sale economics is

Economically equivalent to a sale, regardless of its duration, and should be taxed as such. While a significant number of those who participated in the discussion of the report disagree with our recommendation to eliminate the Safe Harbor completely, a substantial portion of this dissenting group is concerned that the Safe Harbor is too generous. This concern is reflected in our discussion of possible modifications of the Safe Harbor that should be considered if it is retained.

The Bill also contains a new definition of a constructive sale. Instead of asking whether the hedge “substantially eliminates risk of loss and opportunity for gain” — the Treasury Proposal’s standard — the Bill enumerates four examples and adds a catch-all category for transactions “that have substantially the same effect” as these core cases. As we read it, this is a technical change intended to clarify, rather than to alter, the scope of the Treasury Proposal. We believe that the Bill does improve on the Treasury Proposal in some respects. However, like the Treasury Proposal, it leaves ambiguity as to the interest a taxpayer must retain in the appreciated asset in order to fall outside the constructive sale regime. As a way to reduce uncertainty on this point, we suggest examples and other guidance drawn from our last report. We also address other technical issues created by the Bill and discuss how they might be clarified.

The Bill’s effective date for the constructive sale provision is the same as that in the Treasury Proposal. The report suggests that it is appropriate for the Bill to affect transactions entered into prior to the date of enactment, but we do not support the use of January 12, 1996 as the date for distinguishing between constructive sale transactions that must be unwound in order to avoid gain recognition and constructive sales that may be kept open indefinitely. Instead, we recommend that the rule apply to all constructive sales entered into prior to the date of committee action, but with a transition period longer than 30 days.

In addition to its constructive sale proposal, the Bill adds a new provision targeted at “swap funds.” Although we understand the rationale for such legislation, we point out the possible advantages of a regulatory solution, given that the definition of an investment company (which the Bill would modify by amending Section 351 of the Code) is currently found in the regulations. We also note that the Staff of the Joint Committee has proposed an alternative measure. We are currently studying it but are not yet in a position to compare the two. We offer technical comments on the Bill’s approach and recommend providing the Secretary with regulatory authority to ensure that the measure is neither over nor under-inclusive.

We would be pleased to help you in addressing these matters. Please contact me if we can be of assistance.

Very truly yours,

Richard O. Loengard, Jr.
Chair

Enclosure

cc: Hon. Bill Archer
Chair, House Ways & Means Committee
House of Representatives

Hon. William V. Roth, Jr.
Chair, Senate Finance Committee
United States Senate

Hon Charles B. Rangel
Ranking Minority Member,
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Tax Report #901

NEW YORK STATE BAR ASSOCIATION TAX SECTION

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COMMENTS ON H.R. 846

May 21, 1997

Introduction

This report[1] comments on the "constructive sale" provisions and the amendment to Section 351 set out in H.R.846, a bill introduced by Rep. Barbara B. Kennelly (D-CT) on February 26, 1997 (the "Bill").[2] The Bill would limit the ability of a taxpayer to transfer the economic benefits and burdens of an appreciated financial position without recognizing capital gain. Thus, in certain instances the Bill treats such a taxpayer as having made a "constructive sale" of the appreciated position. In this respect, the Bill is like the "constructive sale" proposal issued by the Department of the Treasury in January 1996 ("the Treasury Proposal"),[3] on which we commented in a report issued on March 1, 1996 (the "Prior Report")[4]

However, the Bill differs from the Treasury Proposal in three notable respects. First, the Bill exempts certain short-term hedging transactions from treatment as constructive sales.[5]

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[1] The principal authors of the discussion of the constructive sale proposal are David Schizer and Samuel Dimon. The principal author of the discussion of the proposed amendments to Section 351 is Andrew Berg. Substantial contributions were made by Richard Loengard and Michael Schler. Helpful comments were received from Peter Furci, Bruce Haims, Harold Handler, David Hariton, Sarah Reddick, Judah Rosensweig, Robert Scarborough, Daniel Shelter, and Steven Todrys.

[2] The text of the Bill is attached in Appendix A. The Bill's provision allowing securities traders to mark their positions to market is beyond the scope of this report.

[3] For background on current law, as well as on the Treasury Proposal, please see the discussion under Part II of this Report.

[4] See NYSBA Committee on Financial Instruments, Comments on "Short-Against-the-Box" Proposal (Mar. 1, 1996).

[5] In this Report we use the terms "hedging transactions" and "hedges" in a non-technical sense to refer to transactions that transfer either all or part of the economic benefits and burdens of a position held by a taxpayer. Thus, we do not mean to imply that all transactions referred to as "hedges" should give rise to constructive sales. Also, except where specifically indicated we do not intend any reference to the technical definition of "hedging transactions" found in Treas. Reg. 1.1221-2.

Under this rule (the "Safe Harbor"), any hedging transaction that would otherwise constitute a constructive sale will not be so treated if it is closed by the end of the taxable year and if certain other conditions are satisfied.

Second, the Bill contains a new definition of a constructive sale. Instead of asking whether the hedge "substantially eliminates risk of loss and opportunity for gain," the Treasury Proposal's standard, the Bill enumerates four core examples of a constructive sale — a short sale against the box, an offsetting notional principal contract, a forward contract, and a "long" purchase by a taxpayer who has an appreciated "short" position — and adds a catchall category for transactions "that have substantially the same effect" as the enumerated transactions.[6]

Third, the Bill adds a new provision to eliminate another method available under current law for achieving diversification without incurring capital gains tax: Instead of entering into a hedge, some taxpayers contribute appreciated securities to a partnership which has a diversified portfolio (often called a "swap fund") and receive, in return, a partnership interest representing a share of this diversified portfolio. Under current law, in order for taxpayers to avoid recognizing gain on the contribution, at least 20% of the partnership's assets must be "nonmarketable" securities. The Bill eliminates the distinction between marketable and nonmarketable securities. Thus, under the Bill, contributions trigger gain

[6] See Part II of this Report for descriptions of short sales against the box, offsetting notional principal contracts (i.e., "swaps"), forward contracts, and other hedging transactions.

recognition if more than 80% of the partnership’s assets are securities, whether marketable or nonmarketable.[7]

I. Summary of Principal Comments

A. The Safe Harbor for Short Term Hedges

On balance, we recommend against inclusion of the Safe Harbor, on the grounds that it is inconsistent with the general approach of the constructive sale regime. The Safe Harbor allows a taxpayer who holds an appreciated position to enter into a hedge with “constructive sale” economics without recognizing gain, provided that rules regarding termination of the hedge are followed. As discussed in Part 111(B), we believe that such a transaction is equivalent to a sale, regardless of its duration, and should be taxed as such. Moreover, we are concerned that the Safe Harbor, in allowing taxpayers to maintain constructive sale hedges for 364 days in the first year and eleven of twelve months in subsequent years, will become the exception that swallows the rule. While a significant number of those who participated in the discussion of this report disagree with our recommendation to eliminate the Safe Harbor completely, a substantial portion of this group are concerned that the Safe Harbor is too generous. This concern is reflected in our discussion in Part IH(C) of possible modifications of the Safe Harbor that should be considered if it is retained.

[7] In particular, the Bill modifies the definition of Investment Company under Section 351 and the regulations there-under, and thus, by cross reference, modifies the rules under Section 721 for making tax-free contributions to a partnership.

B. Standard for Constructive Sale

As we read it, the Bill’s new standard represents a technical change that is intended to clarify, rather than to alter, the scope of the Treasury Proposal. We discuss several respects in which the Bill improves on the Treasury Proposal. See Part IV(B). However, like the Treasury Proposal, the Bill leaves considerable ambiguity as to the interest a taxpayer must retain in the appreciated asset in order to fall outside of the constructive sale regime. Accordingly, we continue to advocate, as we did in the Prior Report, that Congress should grant regulatory authority to fashion safe harbors and should consider including guidance in the statute or its legislative history regarding transactions that do not trigger a constructive sale. We provide examples and a suggested safe harbor and presumption that are largely the same as those offered in our Prior Report. See Part IV(C) and Appendix B.

We also point out the that the Bill’s formulation of what constitutes a constructive sale has introduced several new technical issues, which we believe should be addressed as follows:

First, we suggest that the following italicized language be added to the general definition of a constructive sale: “A taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) substantially eliminates opportunity for profit and risk of loss with respect to such position by (A) making a short sale...” This change would preserve the ways in which the Bill is clearer than the Treasury Proposal, while eliminating some of the ways it is less clear.

Second, the rule for swaps suggests that dividends are relevant in determining whether a constructive sale has occurred, but the rule for forwards suggests they are not relevant. See Part IV(D)(2). Addition of the language suggested in the preceding paragraph would confirm that dividends are relevant

Third, Congress should consider modifying or deleting the "special rule for debt," which provides that interest rate swaps are substantially identical to debt instruments. Our preference would be for the opposite rule: "Except as provided in regulations, positions in interest rates will not give rise to constructive sales." Even if this proposal is rejected, we note that the "special rule" is not needed in the Bill in order to preserve the possibility (but not the certainty) that interest rate swaps can cause constructive sales of appreciated debt instruments. As we read it, the Bill (unlike the Treasury Proposal) already provides for this result via its rule for transactions having substantially the same effect as total return swaps. See Part IV(D)(3).

Fourth, we offer technical comments to ensure that Sections (c)(1)(B) and (c)(1)(C) cover only cases which have "total return" economics, so that swaps and forwards with "collar" economics are tested, not under those provisions, but under the catchall category in section (c)(1)(E) — the statutory division of labor that seems to be intended. See Part IV(D)(4).

C. Special Rule For Income in Respect of a Decedent

We offer one comment on the rule regarding income in respect of a decedent, and suggest that an example illustrating the operation of the rule be provided in legislative history. See Part V.

D. Effective Date for Constructive Sales

In addition to applying prospectively to constructive sales that occur after the date of enactment, the Bill affects constructive sales entered into during the period after the Treasury announcement on January 12, 1996 and prior to the date of enactment. Any constructive sales during this “look-back” period trigger gain unless the taxpayer has closed them out — either by selling the appreciated property or by closing the hedge — no later than 30 days after the date of enactment (the “Look-Back Provision”). Moreover, if, after the date of enactment, a taxpayer dies with a pre-enactment constructive sale that was grandfathered by the Bill, and thus has never triggered gain recognition, then the appreciated property (and, apparently, the hedge) will be treated under Section 691 as property constituting rights to receive an item of income in respect of a decedent (the “Basis Step-Up Provision”).

We generally agree with the Basis Step-Up Provision, but would modify it to require a taxpayer to close the hedge substantially more than one day prior to death in order to benefit from a step-up in basis. With respect to the Look-Back Provision, we do not support the use of January 12, 1996 as the date for distinguishing between constructive sale transactions that must be unwound in order to avoid gain recognition and constructive sales that may be kept open indefinitely. If the Bill is to include a look-back rule — and, on balance, we believe it should — we recommend that the rule apply to all constructive sales entered into prior to the date of committee action, but with a transition period longer than 30 days. Dissenting views on these recommendations are noted. See Part VI.

E. Amendment of Section 351

Although we understand the rationale for legislation on this issue, we note the possible advantages of a regulatory solution, given that the rules for investment companies are currently found in regulations. We also note that the Staff of the Joint Committee has crafted an alternative measure. We are currently studying it but are not yet in a position to compare the two. We also offer technical comments, including our view that the Bill should operate in the context of current regulations, so that constraints therein — including the look-through rule for 50%-or-more-owned- subsidiaries — will prevent the Bill from being overbroad. It may be appropriate, however, to lower this 50% test, for example to 25%. Finally, we note the need for a definition of “securities” and recommend that the Bill provide the Secretary with regulatory authority to ensure that the measure is neither over nor under-inclusive. See Part VII.

II. Background[8]

A. Hedging and Gain Recognition Under Current Law

Under generally applicable realization principles, taxpayers do not owe capital gains tax on an appreciated asset until they dispose of it in a taxable sale or exchange.[9] While there is considerable authority for deeming a sale to occur once a taxpayer has transferred the benefits and burdens of ownership of an asset, this authority has developed principally where the property in question is a non-fungible asset, such as an interest in real estate.[10] Another line of authority, which has developed where the property in question is a publicly traded security such as stock, takes a formalistic approach that allows taxpayers to transfer the benefits and burdens of ownership without current recognition of income.

The classic example of such a hedging transaction is the short sale “against the box.” In this transaction, the holder of an appreciated security (typically stock) borrows and sells an identical security, while retaining

[8] Readers who are familiar with common hedging techniques and their treatment under current law should proceed to Part III.

[9] Certain Code provisions require mark-to-market accounting, but this is the exception rather than the rule. See, e.g., Sections 475 and 1256.

[10] See, e.g., Frank Lyon v. United States, 435 U.S. 561 (1978) (ownership depends on “economic substance”); Tennessee Natural Gas Lines, Inc. v. Commissioner, 71 T.C. 74 (1978) (same), acq. 1979-2 C.B. 2; Rev. Rul. 82-150, 1982-2 C. B. 110 (owner of deep in-the-money option to purchase non-traded stock of foreign corporation is the actual owner of stock for foreign personal holding company purposes).

the one he already had.[11] By holding two precisely offsetting positions, one “short” and the other “long,”[12] the taxpayer is insulated from fluctuations in the property’s value — and thus, as an economic matter, has simulated an important feature of a sale. Under current law, however, the transaction is not treated as a sale of the appreciated security unless and until the taxpayer uses this security to cover the short position.[13]

Another hedging transaction that defers taxable gain under current law is a “forward contract,” under which the taxpayer agrees to sell a fixed number of shares in the future for a designated price. Assume, for example, that Seller owns one share of XYZ with a basis of $10, which is trading at $100. Instead of selling the share today, and thus recognizing $90 of capital gain,

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[11] In a “short sale,” a taxpayer sells borrowed stock. The taxpayer is obligated to return identical shares in the future to the party who lent them (the “Stock Lender”). A taxpayer who makes an “uncovered” short sale (as opposed to a short sale “against the box”) will benefit if the stock depreciates in value. If it does, the taxpayer will be able to buy new stock to return to the Stock Lender — a process known as “covering” the short—for less than the amount received on the sale of the borrowed shares. For example, assume the stock is at $100 and the taxpayer borrows a share and sells it, thereby receiving $100. If the stock price declines to $60, the taxpayer can buy a new share for $60 to return to the Stock Lender. Accordingly, the taxpayer has purchased a share for $60 and has sold it for $100 (albeit in the reverse order), thereby recognizing $40 in gain On the other hand, if the taxpayer “sells short” at $100 and the stock price climbs to $200, then it will cost the taxpayer $200 to cover the short, resulting in a $100 loss. Under current law, a short sale is treated as an open transaction: “For income tax purposes a short sale is not deemed to be consummated until delivery of property to close the short sale.” Treas. Reg. 1.1233-1(a)(1).

[12] Holding a “long” position means simply that the taxpayer owns the property (or its economic equivalent) and so will benefit if the property appreciates and lose if it depreciates in value.

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

Seller can enter into a contract with Buyer which provides that, in three years, Seller will sell one share to Buyer for, say, $115.[14] Having "locked in" this purchase price, Seller is generally indifferent to appreciation or depreciation in the share price (although the typical forward leaves him with a benefit or detriment if the dividends prove higher or lower than projected when the forward price was set). If the stock price goes down to $50, he will still receive $115; likewise, if the stock goes to $165, he will still receive $115.

Taxpayers can also hedge without triggering gain under current law by using a "total return" equity swap. Such a swap is a two-party contract under which each party agrees to make payments to the other based on the performance of the underlying swap. The net effect of the swap is to simulate ownership for one party and a short position for the other. Assume, for example, that Taxpayer owns XYZ stock with basis of $10 and that the stock is trading at $100. Taxpayer can simulate a sale of the stock through a "total return" swap with Counterparty, which generally provides for net payments reflecting three variables. First, Taxpayer owes an

[14] The sale price (known as the "forward price") is higher than the current market price (known as the "spot" price) because of the time value of money. Under the forward contract, Buyer does not have to pay the purchase price until maturity. Because the Buyer has the use of his money for three years, he is willing to compensate the Seller for the privilege of paying later — compensation that takes the form of a forward purchase price higher than the current price. Note, though, that the delayed nature of this contract leaves Seller with the dividends paid prior to the delivery of the shares under the forward contract. Accordingly, the purchase price on the forward contract reflects the net effect of two adjustments to the stock's current market price: the purchase price is increased to reflect "interest" on the sale proceeds retained by the buyer until closing of the forward contract, and is decreased to reflect the value of the dividends Seller anticipates receiving in the interim.

amount equal in value to the dividends received on the XYZ stock and any appreciation in its value. Second, Counterparty owes an amount equal to any decline in value of the XYZ stock.[15] Third, Counterparty pays periodic amounts calculated by multiplying the value of the XYZ stock by an interest rate, which reflects the fact that Counterparty retains use of the funds that would have been devoted to purchasing the stock. Accordingly, as long as Counterparty does not default, Taxpayer has transferred the benefits and burdens of ownership of the XYZ stock, and receives a return attributable to the time value of money.[16]

Finally, taxpayers sometimes enter into hedges that are partial rather than total, i.e., the hedge shifts some, but not all, of the benefits and burdens of ownership. One common example of such a transaction is a “collar,” in which a taxpayer buys a put option and writes a call option. Assume that Taxpayer holds XYZ stock that is trading at $100. To secure some protection from a decline in value, the taxpayer can buy a put option from Counterparty, which gives Taxpayer the right, but not the obligation, to sell the stock at a fixed price, say $95, at the end of a fixed period {e.g., three years) or

[15] Payments relating to fluctuations in value of the stock are sometimes calculated periodically, and in other cases only at the maturity of the swap.

[16] Variations on such swaps are possible. In a “compound” swap, the return on one type of property is “swapped” for the return on another. Thus, as in our example above, Taxpayer pays any appreciation and dividends on XYZ and receives payments for depreciation. In addition, Taxpayer could, for instance, receive a payment equal to the dividends and appreciation, if any, on a notional portfolio composed of the stocks in the S&P 500, in which case Taxpayer would owe an amount equal to the depreciation, if any, in the value of this portfolio.

alternatively at any time during the fixed period. The put thus leaves the taxpayer exposed to the first $5 of decline in price, but affords protection thereafter. In order to reduce or eliminate the amount that Taxpayer would otherwise owe Counterparty for selling (or, to use the technical term, “writing”) the put, Taxpayer writes a call option for Counterparty. Under the call, Taxpayer surrenders some, but not all, of the right to appreciation in the stock to Counterparty. Thus, the call might entitle Counterparty to buy the stock from issuer during or at the end of the fixed period for, say, $115.[17] During the term of the collar, therefore, the Taxpayer is exposed to fluctuations in the value of the stock between $95 and $115, but not to fluctuations outside that range.[18]

B. The Treasury Proposal

The Treasury Proposal was introduced in January 1995 in an effort to modify the rules for taxing hedging transactions.[19] It deems a “constructive sale” to occur when taxpayers enter into hedging transactions that “substantially eliminate” both risk of loss and opportunity for gain in appreciated stock, debt

[17] The call and the put may be subject to cash settlement, whereby the party who stands to profit by exercising the option in question receives from the other party the difference between the fair market value of the stock and the option strike price.

[18] Forward contracts and swaps can also be written in a manner that incorporates “collar” economics. See Part IV(D)(4) for an example of such a forward contract

[19] See Department of the Treasury, Treasury Comments on “Short Against the Box” Proposal (Jan. 12, 1997).

instruments, and partnership interests. The appreciated property is deemed sold (and effectively treated as repurchased) for its fair market value on the date of the constructive sale. Under the Treasury Proposal, the length of time that a hedge remains in place is not relevant. As long as the hedge “substantially eliminates” risk of loss and opportunity for gain — if only for a brief interlude — the hedge triggers gain recognition.

C. Our Prior Report

In our Prior Report, we endorsed the Treasury Proposal as applied to short sales against the box and economically similar transactions such as total return equity swaps, on the theory that such transactions are economically similar to actual sales, and should thus be taxed as such. However, we expressed substantial concern that extension of any legislation beyond these core cases — for example, to collars that leave the taxpayer meaningful exposure on the underlying property — would create significant uncertainty, and could impose market distortions and unnecessary costs. Accordingly, we recommended that Congress offer guidance in legislative history about which transactions were permissible, and we offered examples of transactions that we believed should not trigger a constructive sale. We also offered a number of technical comments.

III. The Safe Harbor for Short Term Hedges

A. Description

Under Section (c)(4)(B) of the Bill, a taxpayer who enters into a hedge “which would otherwise be treated as a constructive sale” does not have a constructive sale as long as the taxpayer complies with two requirements: first, the hedge must be “closed before the end of the taxable year”; second, if the taxpayer closes the hedge “during the last 30 days of such taxable year,” the taxpayer cannot enter into “another transaction with substantially the same effect as the closed transaction... during the 31-day period beginning with the date on which such transaction was closed.”

As we read the Bill, if the taxpayer fails to comply with these requirements, the constructive sale is deemed to occur on the date the taxpayer first entered into the hedge, rather than on the (later) date on which the taxpayer fails to comply with the Safe Harbor. The amount constructively realized on the appreciated position equals its fair market value on the (earlier) date of the constructive sale. This is clearly the appropriate result, as the gain “locked in” by the taxpayer is fixed when the hedge is entered into, and is not affected by the value of the appreciated position at the later date when the Safe Harbor boundary is passed.

B. Policy Issues

The underlying rationale for the Bill, as we understand it, is to impose capital gains tax when a hedging transaction is substantially equivalent to a sale. If the basic premise of the Bill is that the enumerated “core” transactions and other transactions that have substantially the same effect should be taxed as dispositions, then it seems irrelevant how long the “constructive sale” transaction remains open. By analogy, if the taxpayer had sold the property at a gain and promptly reacquired it, the taxpayer would have had to pay tax on this gain. There is no equivalent to the “wash sale” rule for gains.[20]

On balance, we believe that the same tax consequences should apply to actual and constructive sales; thus, we recommend that the Safe Harbor be eliminated. Different tax treatment of economically equivalent transactions seems to us to elevate form over substance. Moreover, we are concerned that the Safe Harbor would enable taxpayers with appreciated positions to enter into short sales against the box (or similar transactions) for the maximum permitted period each year (and, as currently drafted, to enter into risk- reduction transactions such as puts or collars during the 31-day “re-exposure” period),[21] thus eliminating almost all risk of loss for

[20] Under the wash sale rules of Section 1091, a taxpayer may not recognize losses on a sale of stock or securities if he reacquires (or enters into a contract or option to reacquire) substantially identical property within 30 days before or after the sale. Similar rules apply to losses incurred on closing a short sale.

[21] See “Hedges During the 31-Day Interval” at Part III(C)(2), infra.

an indefinite period. Hence, we believe that the provision would prove ineffectual in curbing the transactions at which it is aimed. Indeed, we fear that if the Safe Harbor is retained, it may become the exception that swallows the rule. In the view of the majority of those who participated in the discussion of this report, retention of the Safe Harbor would amount to legislative sanction for constructive sale transactions such as the short sale against the box (which is, in most cases, an non-economic transaction predominantly, if not entirely, motivated by tax planning).

A significant number dissented from this recommendation to eliminate the Safe Harbor completely. Supporters of the Safe Harbor (or some more restrictive variant thereof) believe that the Bill can adequately serve its anti-abuse purpose by treating only long-term hedges as constructive sales. In addition, supporters note that short selling against the box is a relatively inexpensive hedging technique, and believe it should remain available for short-term use without triggering gain (though not necessarily for a twelve-month period).[22]

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[22] In support of the Safe Harbor, some find significance in the fact that taxpayers who avail themselves of the Safe Harbor could be subject to the straddle rules — which will be extended to cover short sales against the box, assuming the Administration's proposal in this regard is enacted. See Department of the Treasury, Taxpayer Bill of Rights 3 and Tax Simplification proposals (Apr 16, 1997), reprinted in 97 Tax Notes Today 74-9. Under the straddle rules, gains on the hedging transaction will be taxed annually, while losses and related interest and carrying charges will be capitalized. The straddle rules can be viewed as a "toll charge" for treating a short-term hedge as a separate transaction rather than integrating it with the appreciated position in a constructive sale.

C. Technical Comments.

Assuming that Congress chooses to retain a Safe Harbor, we suggest that certain policy issues as well as technical modifications should be considered. In the view of the majority of those who participated in the discussion of this report, if a Safe Harbor is to be adopted, 30 days each year is far too short a period to be subject to the risk of the market. A number expressed the view that, if anything, the period of the hedge should be only 30 days in any fiscal period, and the taxpayer should be at risk of the market for the balance of the year, i.e., eleven months.

1. <u>Prevent One Year of "Free" Deferral on the Appreciated Asset</u> If a taxpayer is prepared to sell an appreciated asset, the Safe Harbor in its current form could allow him to defer gain on the sale for an additional year without retaining any significant economic exposure. For example, assume that a calendar-year taxpayer is prepared to sell appreciated stock on June 1, 1997. Instead, he can sell short against the box and close the short on December 31 — thereby avoiding a constructive sale by closing the hedge before the end of the taxable year. As drafted, the Safe Harbor arguably permits the taxpayer to sell the stock outright on January 1, thus deferring gain until 1998.[23] If this reading is correct, then the Safe Harbor creates an

[23] The relevant language in Section (c)(4)(B)(ii) of the Bill requires the taxpayer to refrain from "another transaction with substantially the same effect" as the first constructive sale transaction — here, the short sale against the box. It is arguable that an actual sale does not have "substantially the same effect" as a short against the box.

inappropriate result: It offers a year of deferral on the built-in gain, without requiring any significant additional exposure to the benefits and burdens of ownership.

In order to foreclose this result, Congress should clarify that during the 31-day period after closing the short sale (or whatever longer "re-exposure" period Congress may deem appropriate), taxpayers are barred not only from hedging, but also from actual sales.[24]

Alternatively, Congress could require taxpayers who wish to avail themselves of the Safe Harbor to refrain from hedging throughout December. In order to sell in the next year, then, the taxpayer would have to remain exposed for 31 days — that is, during the entire month of December. This alternative is simpler to administer, but imposes what is arguably an unnecessarily burdensome constraint on the timing of when a taxpayer may hedge.

2. Hedges During the 31-Day Interval. Although the Safe Harbor requires taxpayers to wait 31 days before entering into a new hedge with total return economics (such as a short sale against the box), as currently drafted it seems to allow limited hedging during this 31-day period, such as purchase of a put option on the appreciated property or entry into a sufficiently

[24] This could be accomplished by replacing the phrase "another transaction with substantially the same effect as the closed transaction" in Section (c)(4)(ii) with the words "no actual sale of the appreciated position is effected and no transaction described in Section (c)(1) is entered into with respect to such position [during the 31 day period beginning on the date on which such transaction was closed]."

"loose" collar. Specifically, during the 31-day interval, the Bill prohibits only a "transaction with substantially the same effect as the closed transaction," i.e. a hedge that would itself trigger a constructive sale if not closed by year end.[25] Accordingly, a taxpayer would not have a constructive sale if he enters into a short sale on January 1, covers the short position on December 1, purchases a 31 day put option (or enters into a "loose" collar) on the appreciated property on December 1, and then enters into another short sale on January 1 of the following year.[26]

In our view, if it is decided in principle to adopt a Safe Harbor, the pending proposal is unnecessarily generous. If the Safe Harbor's purpose is to screen out transactions that accord only temporary insulation from the economic benefits and burdens of ownership, then the Safe Harbor should require the taxpayer to accept essentially full exposure on the appreciated position during the 31 days after closing the total return hedge. However, writing such a rule is by no means a simple

[25] As currently drafted, the Bill arguably supports the inappropriate conclusion that the Safe Harbor would permit, say, a taxpayer who had closed a short sale to enter into a different type of "constructive sale" transaction (e.g. a "total return" equity swap) within the 31-day period. The language we proposed in the prior footnote resolves this ambiguity.

[26] In contrast, note that a taxpayer's activities are more restricted during the waiting period prescribed in the wash sale rules of Section 1091 — a provision that disallows losses on a sale of stock or securities if substantially identical stock or securities are reacquired within 31 days. During this waiting period, the taxpayer is barred not only from acquiring the property itself but also from steps similar to, but short of, an actual acquisition, such as entering a contract or option to acquire the property. See Section 1091(a).

exercise.[27] This complexity itself is a significant reason for rejecting the current Safe Harbor. We note, however, that if the Safe Harbor covered hedging transactions with a duration significantly shorter than 12 months (say, 30 days), the case for requiring full exposure during the succeeding "re-exposure" period (whether 31 days, or longer) would be less compelling.

IV. Standard for Constructive Sale

A. Description

To define a constructive sale, the Treasury Proposal relies primarily on an abstract formulation — whether the hedge "substantially eliminates risk of loss and opportunity for gain" in the appreciated position. To supplement this formulation, the Treasury Proposal also includes illustrative examples: a short sale against the box and the grant of a call option or acquisition of a put option that are substantially certain to be exercised.[28]

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[27] We assume, for instance, that taxpayers would continue to be allowed to hedge positions other than the appreciated property at issue, and to hedge their portfolio as a whole, e.g., with a put on the S&P 500. In order to distinguish impermissible hedges that relate specifically to the appreciated property, on one hand, from permissible hedges that relate to market risk generally, on the other, Congress might bar the taxpayer from taking positions in "substantially similar or related property" during the 31-day "re-exposure" period. Cf. Treas. Reg. 1.246-5.

[28] See, e.g., Treasury Comments on "Short Against the Box" Proposal (Jan. 12,1996) (also including example of equity swap); Staff of the Joint Committee on Taxation, Description of Tax Provisions Included in a Plan to Achieve a Balanced Budget Submitted to the Congress by the President on January 6,1996 (Jan. 24,1996).

The Bill refocuses the inquiry somewhat. Instead of the substantial elimination inquiry, which does not appear in the Bill, four core cases are enumerated, each of which seems to involve "total return" economics, i.e., hedges that eliminate all or virtually all[29] risk of loss and opportunity for gain: a short sale against the box, a total return equity swap, a forward contract, and a "long" purchase by a taxpayer who has an appreciated short position. To supplement these four categories, the Bill adds a catchall category for transactions "that have substantially the same effect" as the enumerated transactions.

As we read it, the Bill's new standard represents a technical change that is intended to clarify, rather than to alter, the scope of the Treasury Proposal. In our Prior Report, we read the substantial elimination standard as "cover[ing] the core cases as well as transactions that closely approximate the core cases."[30] This description is, if anything, even more applicable to the test in the new Bill. Moreover, "substantial" is still the key word: the old inquiry asks whether the hedge "substantially" eliminates risk of loss and opportunity for gain; the new "catchall" inquiry asks whether the hedge has "substantially" the same effect as one of the enumerated transactions, each of which eliminates all or virtually all risk of loss and opportunity for gain. At bottom, each is a

[29] We add "virtually all" because the four core cases cover transactions involving the same or "substantially identical" property.

[30] See Prior Report, at 3.

“substantial elimination” inquiry, although the new test seems more concrete because it is grounded on examples, rather than on an abstract standard.

B. Technical Merits of the Bill

1. Aggregate Approach for Measuring Retained Interest As we read it, the Bill clarifies a potentially significant ambiguity in the Treasury Proposal. Under the latter, it was unclear whether retained risk of loss and opportunity for gain should be weighed on an aggregate basis in determining whether a constructive sale had occurred.[31] In other words, where a taxpayer retained some risk of loss — but not enough, without more, to avoid a constructive sale — and some opportunity for gain — but, again, not enough, without more, to avoid a constructive sale — it was unclear whether the retained risk of loss and opportunity for gain, in combination, could nonetheless be sufficient to take the transaction outside of the constructive sale rule. Under the Bill, such aggregation is permissible. Thus, the inquiry whether a transaction that does not have “total return” economics has “substantially the same effect” as one of the core cases calls for an evaluation of the overall substance of the transaction, rather than a separate weighing of retained risk of loss and opportunity for gain. This resolution seems to us the better policy. It would be helpful if legislative history confirmed this interpretation.

[31] See id., at 6-7 & n. 9.

2. Elimination of Special Rule for Options We also appreciate that the Bill has removed the Treasury Proposal's special test for options, i.e., whether the option is substantially certain to be exercised. As we indicated in our Prior Report, we believe that the addition of this test is either unnecessary (if it yields the same conclusion as the "substantial elimination" test) or confusing.[32]

3. Dynamic Hedging No Longer A Concern In our Prior Report, we asked for clarification that the Treasury Proposal does not cover dynamic hedging, and we believe that the Bill has provided such clarification.[33] In dynamic hedging, taxpayers monitor the correlation between price movements in the hedged asset and price movements in derivatives (such as call options). Based on this correlation, called "delta," some taxpayers create a portfolio of derivatives whose net price movements perfectly offset price movements in the hedged asset. For example, assume the taxpayer determines, based on options pricing models, that every time the price of stock XYZ increases by a dollar, an out-of-the money call on the stock declines by 25 cents; accordingly, the taxpayer can hedge its position by selling four out-of-the-money calls. Because "delta" constantly changes as the price changes, taxpayers must constantly change the composition of their hedging portfolio in order to ensure that its price movements continue to offset fluctuations in the hedged asset —

[32] See id., at 7-8.

[33] See id., at 14-17.

hence the name “dynamic.” As we indicated in our Prior Report, such hedging does not have the “feel” of a current sale; it involves an ongoing series of transactions, rather than a single event in which the taxpayer surrenders the benefits and burdens of ownership. Because each of the Bill’s core cases constitutes such a single event, rather than an ongoing series of transactions, we believe that dynamic hedging does not have “substantially the same effect” as any of the enumerated transactions, and thus is not covered by the Bill.

4. <u>Appreciated Short Positions Covered</u> In our Prior Report, we requested clarification that there would be a constructive sale when the holder of an appreciated short position acquires an offsetting long position but does not cover the short.[34] Such clarification has been provided by inclusion of (c)(1)(D), which finds a constructive sale where a taxpayer “[i]n the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) [i.e., offsetting notional principal contracts and forwards] with respect to any property, acquires the same or substantially identical property.”

A further clarification would be useful, though. In describing the consequences of a constructive sale in Section (a)(1), the Bill indicates that “the taxpayer shall recognize gain as if such position were sold for

[34] See id., at 29.

its fair market value..." (Emphasis added.) As a technical matter, though, a short position is not "sold." Accordingly, we would provide instead that "the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated...."

5. <u>Forward Contracts Covered</u> In our Prior Report, we noted that opportunity for gain should be viewed as substantially eliminated even if the taxpayer enters into a forward contract that locks in gain attributable to the time value of money.[35] The Bill makes clear that it applies to such forward contracts, which are one of the four core cases.[36]

6. <u>No Inference Regarding Collateral Consequences Under Other Code Sections</u> In our Prior Report, we noted that the Treasury Proposal, as drafted, might cause taxpayers with constructive sales not only to recognize gain, but also to have a sale for all purposes of the Code: "If there is a constructive sale of an appreciated position," the Treasury Proposal provided, "such position shall be treated as sold for its fair market value on the date of the constructive sale (and any gain shall be taken into account for the taxable year which includes such date)..." (emphasis added). In removing the italicized phrase, the Bill appropriately avoids the implication that a constructive sale is a sale for all

[35] See id., at 8-9.

[36] We do have technical suggestions for improving the definition of "forward contract," as discussed at Part IV(D)(4), infra.

purposes of the Code: “If there is a constructive sale of an appreciated financial position,” the Bill provides, “the taxpayer shall recognize gain as if such position were sold for its fair market value on the date of such constructive sale (and any gain shall be taken into account for the taxable year which includes such date)....” As we read the Bill, its sole consequence is to trigger gain recognition. It does not address whether taxpayers who hedge have sales for other purposes of the Code — for example, ownership changes under Section 382, deconsolidation under the consolidated return rules, or continuity of interest. Present law will continue to govern such determinations. Indeed, it is possible that a hedge will cause a deemed sale for such purposes even if it does not cause a constructive sale under the Bill.

C. Need for General Guidance

The scope of the Bill, like that of the Treasury Proposal, is ambiguous. This ambiguity is of particular concern because the statute is self-executing, so that taxpayers will immediately confront the question whether their hedges have “substantially the same effect” as one of the enumerated transactions.[37] The statute or legislative history should provide further guidance about what transactions remain unaffected by the Bill.

[37] As we indicated in our Prior Report, we agree that the statute should be self-executing. A statute in which the catchall test did not become effective until the Secretary had promulgated regulations might not be sufficiently effective, given the essentially unlimited variety of transactions that are technically distinguishable from the enumerated transactions but yield comparable results. See Prior Report, at 3.

Otherwise, the resulting uncertainty will affect a host of transactions in ways difficult to foresee, and could impose potentially costly and unnecessary market distortions and inefficiencies.

While we believe it is important that farther guidance be available immediately, it is not essential that this guidance be permanent or in the form of absolute safe harbors. We understand that Congress may hesitate to provide detailed guidance out of reluctance to constrain the Secretary's choices when regulations ultimately are promulgated, as well as out of concern that any bright-line guidance could produce inappropriate results in unanticipated cases. Accordingly, some (or all) of the guidance about transactions that do not trigger constructive sales can be offered on an interim basis only – that is, subject to revision by the Secretary in the form of regulations that would have prospective effect. Thus, if the guidance ultimately proves too generous to taxpayers (or, alternatively, too harsh), the Secretary will have the freedom to refine the rules based on this experience. Moreover, Congress can provide such guidance as presumptions, rather than as safe harbors. This approach would minimize the risk that taxpayers will take advantage of the proffered criteria in unforeseen ways.

As for the substance of the guidance, we offer two points that we hope could be addressed. In addition, we suggest that the Bill provide explicit regulatory authority for the Secretary to promulgate safe harbors or favorable presumptions.

First, it would be helpful if the statute or its legislative history provided general guidance, in the form of criteria that a hedge with collar economics must fulfill in order (presumptively, at least) to avoid being a constructive sale. Accordingly, as in our Prior Report, we recommend such a safe harbor or presumption for any collar or similar hedge that has: (i) a relatively short term (e.g., not exceeding three or, alternatively, five years); (ii) a total “spread” of at least 20% of the current trading price of the hedged security, and (iii) a spread that includes the current trading price of the hedged security. This standard is further discussed and illustrated by the materials, drawn from our Prior Report, reprinted in Appendix B under the heading “Out-of-the-Money Collars.”

Second, as in our Prior Report, we recommend allowing a presumption based on options pricing, which is more accurate but less easily administrable than the “gross spread” approach. We recommend a presumption that taxpayers do not have a constructive sale if the value of the risk of loss and/or opportunity for gain they retain, as measured by options pricing, is a meaningful portion of the value of appreciation and depreciation in total. For example, if the stock is trading at $100 and a taxpayer buys a put with a strike price at $100 and sells a call with a strike price at $115, we would determine the value of the retained opportunity for gain, i.e., the appreciation between $100 and $115. This value is given by the difference between the price of a call at $115 (which represents the value of all appreciation above $115) and the price of a call at $100 (which, correspondingly, represents the value of all appreciation above $100). This difference would be compared with — and, in particular, divided by — the total value of all opportunity for gain and risk of loss, in combination (i.e., the sum of the value of a call with a strike price at $100 and the value of a put with a strike price at $100). This quotient yields the relative value of the retained opportunity for gain, as a percentage of the value of all risk of loss and opportunity for gain, in combination. Under our recommendation, as long as this quotient exceeds a numerical threshold satisfactory to Congress, there will presumptively be no constructive sale.

In recommending a numerical threshold, we note that the options pricing approach is more accurate than the presumption based on a gross spread, and so a smaller margin for error is needed.[38] We consider 10% to be a relatively conservative interpretation of the statutory language for purposes of the options pricing model.[39] Congress may also conclude that a lower retained exposure should suffice to create a favorable

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[38] See Prior Report, at 10-14, 20-22 (discussing imprecision of "gross spread" approach). As we indicated in our Prior Report, though, the options pricing approach is not perfectly precise. To value an option, one must make assumptions — as to which reasonable minds may differ — about the volatility of the underlying stock.

[39] By way of analogy, in determining whether "substantially all the assets" in a reorganization have been transferred, the Service's ruling position is that 90% of the net assets must be transferred. See Rev. Proc. 77-37, 1977-2 C.B. 568. Although the Rev. Proc. also requires that 70% of the gross assets be transferred, the net value test seems to us clearly more relevant as an analogy when testing for net economic effect, which is what the Bill's "substantially the same effect" standard points to.

presumption.[40] The question of what percentage is the appropriate basis for a presumption or safe harbor (both in the case of the gross spread and options pricing approaches) is, of course, a policy judgment rather than a technical question. Ultimately, our priority is not to advocate any particular number or any particular form of guidance, but to emphasize that guidance in some form is important.

D. Need for Technical Clarifications

1. Combination of the Treasury Proposal and the Bill's Standard Congress could preserve the ways in which the Bill is clearer than the Treasury Proposal, while eliminating some of the ways in which it is less clear, by combining the two. In particular, prior to the four enumerated examples and the catchall test, Section (c)(1) could provide: "In general — A taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) eliminates substantially all risk of loss and opportunity for profit with respect to such

[40] In our Prior Report, we noted 10% and 20% as possible standards. See Prior Report, at 12. Yet because our approach has changed, a transaction that satisfied the 20% standard under last year's methodology would not satisfy a 20% test under our new methodology (and, indeed, would register closer to 10%). The change is that we now test risk of loss together with opportunity for gain, rather than testing the two separately — a methodology permissible (and indeed, we believe, required) under the Bill, but apparently not under the Treasury Proposal. See Part IV(B)(1), supra (discussing permissibility of aggregation of risk and loss under the Bill, in contrast with Treasury Proposal). Accordingly, we no longer test the opportunity for gain retained by the taxpayer as a proportion of total opportunity for gain, but rather as a proportion of total opportunity for gain and risk of loss in combination. In other words, we have very substantially increased the denominator of our quotient, and thus the standard we apply should be reduced accordingly in order to produce equivalent results.

appreciated financial position by" making a short sale of the same or substantially identical property, entering into an offsetting notional principal contract, etc.[41] This formulation would help address certain of the technical issues raised immediately below (including the relevance of retained periodic payments and the treatment of swaps and forward contracts with collar economics). Even if this suggestion is accepted, however, we would still recommend making the additional clarifying changes recommended below.

2. Relevance of Retained Periodic Payments. In determining whether a taxpayer's retained economic interest in appreciated property is sufficient to avoid a constructive sale, we consider it appropriate as a policy matter to consider the taxpayer's exposure to fluctuations in periodic payments along with his exposure to fluctuations in resale price. As with the Treasury Proposal,[42] though, we find the Bill as currently drafted unclear on the relevance of periodic payments.

The treatment of swaps suggests that dividend exposure is relevant. To qualify as an "offsetting notional principal contract" — that is, the kind of swap that triggers a constructive sale — the swap must include an "agreement to pay the investment yield (including appreciation)." Section (d)(2) (emphasis added). The

[41] We use the word "profit," rather than "gain," because we believe that opportunity to earn dividends or interest is a potentially meaningful aspect of ownership. See Part IV(D)(2), infra.

[42] See Prior Report, at 9, n. 11.

implication of the word “including” is that the swap must also require payment of investment yield other than appreciation, e.g., dividends. In other words, a swap that paid appreciation but not dividends should not qualify as an “offsetting notional principal contract” under (c)(1)(B) (although it might qualify under (c)(1)(E) as a “transaction having substantially the same effect,” depending upon how economically meaningful the dividend exposure was).

In contrast, dividend exposure does not seem relevant under the forward contract rule of (c)(1)(C). The test — whether a taxpayer has “enter[ed] into a futures or forward contract to deliver the same or substantially identical property” — makes no mention of dividends. Thus a taxpayer holding a high-dividend paying stock who enters a “forward contract to deliver” the stock in the future seems to have a constructive sale under this definition, without regard to whether the taxpayer’s dividend exposure is economically significant.

We prefer a rule that considers dividend exposure and believe that the language we have suggested under Part IV(D)(1) accomplishes this result.

3. <u>Debt Instruments</u>

<u>Special Rule</u>. The Bill includes the same language found in the Treasury Proposal under the heading “special rule for debt.” In the context of the Treasury Proposal, this “special rule” creates the possibility, but not the certainty, that an interest rate swap will cause a constructive sale. The rule provides: “For purposes of

paragraph (1)(A)," i.e., the paragraph providing that a position that substantially eliminates risk of loss and opportunity for gain causes a constructive sale, "positions in interest rates shall be treated as positions in property which is substantially identical to debt instruments." Thus there is a constructive sale under the Treasury Proposal only if the effect of the swap is to "substantially eliminate" risk of loss and opportunity for gain. Although the swap does lock in gain attributable to movements in interest rates, the swap affords no insulation from either fluctuations in value due to the issuer's credit or, relatedly, from a default on the repayment of interest or principal. Accordingly, application of this test might yield a constructive sale for a Treasury bond, but not for "junk" debt.

As noted in our Prior Report,[43] we question the need for a rule that accords constructive sale treatment to positions in interest rates that hedge debt instruments held by the taxpayer. Thus, we would welcome a rule stating that "except as provided in regulations, positions in interest rates will not give rise to constructive sales."

If this suggestion is not accepted, we would note that the Bill does not need the special rule for debt in order to achieve the balance struck in the Treasury Proposal (as modified) — i.e., the possibility, but not the certainty, that an interest rate swap causes a

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[43] See id, at 30-33.

constructive sale. This language is unnecessary because, unlike the Treasury Proposal, the Bill's rule for "offsetting notional principal contracts," together with the catchall for transactions having "substantially the same effect," is adequate for testing interest rate swaps.[44] Such swaps should not qualify under the core case in (c)(1)(B) because these swaps are not total return instruments. They insulate the taxpayer from only some of the economics, i.e., changes in value attributable to interest rate, but not credit, fluctuations. However, in situations where exposure to the issuer's credit is not economically meaningful (e.g., for appreciated Treasuries), an interest rate swap could qualify as a transaction having "substantially the same effect" as an offsetting notional principal contract.

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[44] Not only is inclusion of the special rule for debt instruments unnecessary in the Bill, but it is somewhat confusing as well. Its effect is arguably to create a per se rule that interest rate swaps cause constructive sales. As in the Treasury Proposal, the Bill says: "For purposes of paragraph (1)(A), positions in interest rates shall be treated as positions in property which are substantially identical to debt instruments." The cross-reference to (1)(A), though, is no longer to the substantial elimination test, but to the Bill's Section (c)(1)(A), which provides: "A taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) (A) makes a short sale of the same or substantially identical property." In combination, these two provisions provide: first, that the "short sale" of substantially identical property is a constructive sale; and second, that an interest rate swap is substantially identical to debt It follows, therefore, that a "short sale" of an interest rate swap automatically is a constructive sale. This concept is somewhat ambiguous, because parties generally "enter into" swaps rather than "selling" them. Arguably, though, this language means that a taxpayer who enters into the "short" side of an interest rate swap — that is, a taxpayer who swaps an amount equal to the coupon on an appreciated debt instrument for a floating rate (while retaining exposure to the issuer's credit, as described above) — automatically has a constructive sale, even if the taxpayer's retained exposure to credit and principal ride is meaningful. Such a per se approach is not consistent with the approach taken for debt in the Treasury Proposal, and it is not consistent with the Bill's approach for other property.

Integration In our experience, taxpayers who enter into hedging transactions with respect to debt they hold frequently use integration (e.g., under Treas. Reg. 1.1275-6). We assume that such integration would not preempt constructive sale treatment for the debt instrument being hedged; if it did, there would be little point in subjecting debt to constructive sale scrutiny at all.[45] Legislative history clarifying this point would be helpful, though.

4. Core Cases: Total Return Economics. The following technical comments are meant to ensure that the core cases in sections (c)(1)(A) through (c)(1)(D) each have “total return” economics (i.e., each leaves the taxpayer with no risk of loss or opportunity for gain in the appreciated property) and that the catchall category in section (c)(1)(E) is used to test hedges with collar economics (i.e., those that leave the taxpayer with some risk of loss and/or opportunity for gain) — the statutory division of labor that seems to be intended.

[45] The technical argument that integration preempts a constructive sale is based on the language of the integration rules, which provide, in effect, that they alone govern the component pieces of the integrated transaction. See Treas. Reg. 1.1275-6(a) (“The integrated transaction is generally subject to the rules of this section rather than the rules to which each component of the transaction would be subject on a separate basis.”). On the other hand, the integration rules contain the qualifier “generally.” In addition, the constructive sale rule is not one that applies two each component “on a separate basis.” Like integration, constructive sales occur only when the two components merge; accordingly, the constructive sale role is arguably not the sort of rule that is “preempted.”

Forwards. We believe there is unintended ambiguity in applying (c)(1)(C) — which finds a constructive sale when a taxpayer "enters into a futures or forward contract to deliver the same or substantially identical property" — to variable delivery forward contracts, i.e., forwards to deliver a number of shares that varies with the share price at maturity. Such instruments are common in the markets today.[46]

As illustrated by the following example, these forwards have collar economics. Assume that Taxpayer is a domestic corporation that holds one million shares of common stock of XYZ Corporation (the "Shares"), which represents 5% of the stock of XYZ. Taxpayer's basis is $ 20, and the Shares are currently trading at $ 100. Taxpayer issues to public holders ("Holders") one million prepaid forward contracts ("Forwards") for $ 82 each. Under the Forwards, Taxpayer is obligated to deliver a variable amount of stock (or the cash value thereof) in three years. Taxpayer retains all appreciation between $ 100 to $ 115 and 13% of appreciation above $ 115 (as well as exposure to dividend fluctuations). Holders receive 87% of the appreciation above $ 115, and bear the full risk of declines in the price of the Shares. To implement these collar economics, the amount of stock delivered under the Forward will vary with the stock price at maturity:

[46] See, e.g., AJL PEPS Trust (Oct 24, 1995); Dole Automatic Common Exchange Security Trust (Aug. 8, 1996); Contifinancial STRYPES Trust (preliminary prospectus dated Feb. 14, 1997); see also Salomon Inc. Debt Exchangeable For Common Stock of Cincinnati Bell, Inc. (Oct 22, 1996) (mandatorily exchangeable note treated as a forward contract for tax purposes).

> If the stock price is below $ 100, Taxpayer delivers a full share (or the cash value thereof.). Thus Taxpayer eliminates all risk of loss on the stock (the equivalent of acquiring a put with a strike price of $ 100).
>
> If the stock is trading between $ 100 and $ 115, Taxpayer delivers a fractional share whose value is $ 100 (or $100 in cash); the size of the fractional share equals 100 divided by the market price at maturity, an amount that will be between 1 and .87. If the stock is trading above $ 115, Taxpayer delivers .87 shares (or the cash value thereof). Thus, Taxpayer retains all appreciation on the stock in the range between $ 100 and $ 115 and 13% of the appreciation on the stock above $ 115 (the equivalent of Taxpayer's retaining a call with a strike price of $ 100 on all of the stock and selling a call with a strike price of $ 115 on 87% of the stock).

Because this hedge has collar economics, we believe it should be tested under (c)(1)(E) to determine whether it has "substantially the same effect" as a forward with total return economics.[47] Although we believe this is the better reading, the language of (c)(1)(C) can be read to apply to this Forward, notwithstanding the collar economics, because the Forward is, strictly

[47] We believe that such an instrument generally would not cause a constructive sale under the "substantially the same effect" test See the discussion in Appendix B under the heading "Portfolio Exchangeable Instrument" for an analysis of how our proposed options pricing model would be applied to a similar instrument

speaking, a “futures or forward contract to deliver the same or substantially identical property.”

To clarify this point, the definition of forward contracts in (d)(1) could be modified as follows: “The term ‘forward contract” means a contract to deliver a fixed number of shares of stock, debt instruments or partnership interests for a fixed price. The term forward contract’ includes a fully or partially prepaid forward contract.”[48]

<u>Swaps</u>. The statutory definition provides: “The term ‘offsetting notional principal contract’ means, with respect to any property, an agreement to pay the investment yield (including appreciation) on such property for a specified period in exchange for the right to be reimbursed for any decline in the value of such property and for other consideration.” The better reading of this definition, we believe, is that “an agreement to pay the investment yield” means an agreement to pay the entire investment yield — not just a portion of it — and that “the right to be reimbursed for any decline” means the right to be reimbursed for the entire decline — and, again, not just a portion of it. Clarification on this point would be helpful.
For example, the relevant portions of the definition could read “an agreement to pay the entire investment yield (including all payments received, and the entire increase in value of the property)” and “the

[48] This language also eliminates this possibility that the rule regarding forward contracts could be interpreted to cover a contract to deliver stock for a price equal to its fair market value at the time of delivery — an arrangement that clearly should not constitute a constructive sale.

right to be reimbursed for the entire decline in the value of such property."[49]

Under this formulation, swaps with collar economics will be tested only under (c)(1)(E). The relevant question will be whether they have "substantially the same effect" as such a total return swap; if they do, in that they leave the taxpayer without meaningful exposure on the underlying position, the swap will cause a constructive sale.

5. "Compound" Swaps A total return swap simulates not only a sale, but also a notional use of the sale proceeds. For example, if a taxpayer holds XYZ stock, the taxpayer can use a swap to simulate a sale by making payments equal to appreciation in the stock and dividends received thereon and by receiving payments equal to depreciation in the stock. In addition, the taxpayer receives other consideration. Usually, the taxpayer receives payments based on Libor or a fixed interest rate (the notional equivalent of depositing the sale proceeds in a bank account). However, the swap can also simulate notional reinvestment in property that can potentially depreciate, in which case the taxpayer may have to make payments as well. Thus, in addition to "swapping out" of XYZ stock — by paying the appreciation and dividends on XYZ and receiving the depreciation— the

[49] Also, it might be preferable to use the phrase "total return" notional principal contract to avoid confusion from use of the term "offsetting," which has a different meaning in Section 1092.

taxpayer can at the same time “swap into” a new notional investment such as a notional portfolio replicating the S&P 500. Accordingly, the taxpayer also receives the appreciation and the notional average dividend yield of the notional portfolio, and the taxpayer also must pay the amount of any depreciation in the value of this notional portfolio. The statutory definition seems to have been written only with the former type of “sale” swap in mind and is less clear in its application to such “compound” swaps. In particular, the definition anticipates that the taxpayer will receive “other consideration” (such as a Libor payment), but does not refer to the possibility that the taxpayer will have to pay the decline in the value of a notional reinvestment.[50] It would be odd to read the term “other consideration” as including payments the taxpayer is obligated to make.

Although the taxpayer who engages in a “compound” swap remains exposed to risk of loss, this is due to the risk of decline in value of the notional reinvestment position, rather than decline in value of the taxpayer’s appreciated position. It seems consistent with the approach of the Bill to treat such a swap as a constructive sale of the taxpayer’s appreciated position (assuming, obviously, that the swap sufficiently insulates the taxpayer from risk of loss and opportunity

[50] Section (d)(2) of the Bill provides: “The term 'offsetting notional principal contract’ means, with respect to any property, an agreement to pay the investment yield (including appreciation) on such property for a specified period in exchange for the right to be reimbursed for any decline in the value of such property and for other consideration.”

for gain in the appreciated position). Arguably, the "substantially the same effect" test of (c)(1)(E) supports this result. However, it would seem preferable to modify the statutory definitions by adding, after the language "investment yield (including appreciation) on such property," the phrase "(and may include the obligation to pay additional consideration)."[51]

6. Statutory Cross-references We assume that the term "substantially identical" is meant to have the same meaning in (c)(1)(A) and (c)(1)(D) as in Section 1091. A statement to this effect in the statute or in legislative history would clarify the point.

Similarly, Congress may wish to clarify that the term "notional principal contract" in (c)(1)(B) and (d)(2) has the same meaning as in the regulations under Treas. Reg. 1.446-3(c) and Treas. Reg. 1.863-7.

V. Income in Respect of a Decedent

In the provisions regarding income in respect of a decedent under "effective date" at the end of the Bill, see (d)(2)(B), there is a reference to "such [appreciated] position (and any property related thereto as determined under the principles of Section 1259(d)(1) ...." The cross-reference seems to be a vestige from a

[51] Under this formulation, a "compound" swap in which the taxpayer completely eliminated risk of loss and opportunity for profit with respect to appreciated property and took on exposure to the economics of another position would be covered by subsection (c)(1)(B) of the statute, while the effect of a "compound" swap with, for instance, collar economics with respect to the taxpayer's appreciated position would be analyzed under subsection (c)(1)(E). It would probably be desirable to confirm the intended operation of these provisions in legislative history.

prior draft of the statutory language. We believe, by comparison to the Treasury Proposal, that the intended reference is to (e)(3)("Multiple Positions in Property"). However, even as so modified, the effect of the cross-reference is not entirely clear to us. Is it intended that both the appreciated position and the short position be treated as "property constituting rights to receive an item of income in respect of a decedent"? We are not entirely sure how this rule would operate in the case of the short position. Is it intended that the closing of the short position by the estate would result in the same tax treatment as if the decedent had closed the short position prior to dying? An illustrative example in legislative history would be helpful.

VI. The Effective Date

The Bill retains the same effective date that appeared in the Department of the Treasury's release of January 12, 1996. In addition to applying prospectively to constructive sales that occur after the date of enactment, the Bill looks back to constructive sales entered into during the period after the Treasury announcement on January 12, 1996 and prior to the date of enactment (the "Look-Back Period"). Any constructive sales during the Look-Back Period trigger gain unless the taxpayer has closed them out — either by selling the appreciated property or by closing the hedge — no later than 30 days after the date of enactment (the "Look-Back Provision"). Finally, if, after the date of enactment, a taxpayer dies with a constructive sale that has been grandfathered, and thus has never resulted in gain recognition, the appreciated property (and, apparently, the hedge)[52] will be treated under Section 691 as property constituting rights to receive an item of income in respect of a decedent (the “Basis Step-Up Provision”).

The Bill thus has two features that affect transactions entered into under prior law. First, the Basis Step-Up Provision affects taxpayers who die with an open hedge that would qualify as a constructive sale under the Bill, even if the taxpayer entered into this hedge before the Treasury Proposal was announced. Second, the Look-Back Provision eliminates the ability of taxpayers who enter into constructive sale transactions during the Look-Back Period to retain both their hedge and their appreciated position without recognizing gain.

As discussed below, we generally agree with the Basis Step-Up Provision, but would modify it to require a taxpayer to close the hedge substantially more than one day prior to death in order to benefit from a step-up in basis. With respect to the Look-Back Provision, we do not support the use of January 12, 1996 as the date for distinguishing between constructive sale transactions that must be unwound in order to avoid gain recognition and constructive sales that may be kept open indefinitely. If the Bill is to include some version of the Look-Back Provision — and, on balance, we believe it should — we recommend that the rule apply to all

[52] See “Income in Respect of a Decedent,” at Part V, supra.

constructive sales entered into prior to the date of committee action, but would allow a longer transition period than 30 days.[53] Dissenting views on these recommendations are noted.

1. Basis Step-Up Provision We support the Basis Step-Up provision — but not on the theory that taxpayers were on notice of a change in law or that they had attained results that never were contemplated by the administrators of the tax system.[54] Rather, our support is based on the view that the result under prior law is inappropriate. Allowing the basis step-up for taxpayers who have “constructive sale” hedges in place at death permits them not just to defer tax, but to eliminate it entirely — a result that we believe should not be allowed to continue.[55]

Although we agree with the spirit of the Basis Step-Up Provision, we are concerned that as drafted it will not achieve the intended result. By closing the hedge before death — indeed, even the day before — taxpayers regain the basis step-up. Such a rule favors those who, for

[53] We do not believe that more than 30 days of transition relief should be granted to taxpayers who enter into constructive sale transactions after the date of committee action. Granting longer transition relief to such taxpayers would encourage entry into tax-motivated constructive sales transactions with a view to taking advantage of the expected transition relief.

[54] The Basis Step-Up Provision applies to taxpayers who were not on notice, in that it covers those who hedged before the Treasury Proposal was announced. Nor does the measure modify a result that was an unanticipated loophole under prior law; a published revenue ruling analyzes the estate tax consequences of dying with a short sale against the box in place. See Rev. Rul. 73-524, 1973-2 C.B. 307.

[55] We note, though, that this was not the unanimous view of those who participated in the discussion of this report.

lack of a better phrase, die slowly enough to close their hedge. It is an odd result that only taxpayers who die unexpectedly or are poorly advised lose the basis step-up. Moreover, if the policy goal here is to reserve the step-up for those who retain the benefits and burdens of ownership — and thus truly is owners of the appreciated property at the time of death[56] — it is questionable at best whether a single day's exposure is an apt proxy for such ownership. It seems to us that the Bill should require substantially longer exposure to the economics of the property prior to the date of death.[57]

2. Look-Back to January 12, 1996 Treasury presumably crafted the Treasury Proposal to be retroactive to January 12, 1996 (with a 30 day unwind period, as described above) on the theory that the Treasury Proposal was announced that day, thereby giving taxpayers notice of the proposed change in law.

We are concerned, though, that the subsequent statement by the Chairmen of the House Ways and Means and Senate Finance Committees countermanded, or at least compromised, the notice given on January 12, 1996:[58] "So as not to disrupt normal market activities and business transactions during this period of deliberation," the

[56] Compare Treas. Reg. 1.691(a)-5 (installment obligation gives rise to income in respect of a decedent and thus, pursuant to Section 1014(c), is not eligible for basis step-up).

[57] The importance of this issue is significantly diminished, however, if the Look-Back Provision is modified along the lines we suggest in the text that follows.

[58] We note again, though, that this was not the unanimous view of those who participated in discussion of this report.

Chairmen said, “it is intended that the effective date of any of these legislative proposals that may be adopted by either of the tax-writing committees will be no earlier than the date of appropriate congressional action.”[59] Although this statement applied to a range of transactions — and thus could not be said to manifest a particular intent to roll back the effective date of the Treasury Proposal — quite a few taxpayers took it to mean that their hedging transactions during the period prior to “appropriate congressional action” would not be affected by the announcement date of the Treasury Proposal. This interpretation seems reasonable in this respect at least: the statement of the Chairmen seemed to deny any special relevance to the introduction of the Treasury Proposal. In other words, although taxpayers were aware that the rules governing short sales against the box might be changed, taxpayers were no longer on reasonably clear notice that this change would be effective as of January 12, 1996.[60]

3. Indefinite Grandfathering Although we do not support tying the Look-Back Provision rule to January 12, 1996, we do believe that some form of the rule would be appropriate. We see no particular reason why a taxpayer who has sold short against the box prior to the date of committee action should be allowed to keep the short

[59] Roth, Archer Joint Statement on Budget Revenue Provision Effective Dates, 96 TNT 64-55 (Apr. 1, 1996).

[60] To the extent that the Bill in its current form is broader than the Treasury Proposal (for example, in its apparently per se approach to forward contracts and notional principal contracts, including those with collar economics), notice was deficient in another respect: taxpayers who read the “substantial elimination” test could not have known that their transactions would be caught under the Bill’s broader language. To the extent, though, that the Bill is narrowed through technical amendments along the lines we have suggested, this notice concern is addressed.

position in place indefinitely.[61] In this sense, we believe that application of the Bill to transactions entered into under prior law is justified — again, not on the theory that taxpayers were on notice of a change in law or that they had attained results that never were contemplated by the administrators of the tax system[62] — but on the theory that indefinite deferral is an inappropriate result that ought to be foreclosed. Indeed, given the time value of money, indefinite deferral of a tax can approximate its elimination.

4. Unwind Period We believe that taxpayers who entered into constructive sales prior to the date of committee action should have more than 30 days of transition relief before they are deemed to have a sale under the Bill. While we do not have a specific recommendation on how long the transition period should be, we believe that the following considerations are relevant.

In choosing the appropriate length of time, Congress may wish to assess how difficult or costly it will be to unwind the “constructive sale” position. Some hedges, including public securities and private derivative contracts, make no provision for unwinding (e.g., non-callable securities) or impose contractual penalties for doing so. For others, such as short sales against the box, there will likely be no legal impediment to closing the hedge or any resulting contractual

[61] We note again though, that this was not the unanimous view of those who participated in discussion of this report.

[62] This latter theory is unpersuasive because there is a published revenue ruling permitting the deferral of gain by taxpayers who enter into short sales against the box. See Rev. Rul. 72-478, 1972-2 C.B. 487.

penalty, but there may be practical impediments to closing it without using the appreciated position that was being hedged — and thus recognizing the built-in gain. Taxpayers might have difficulty securing new shares to close the short sale because the market in the shares is illiquid. Alternatively, they might not have sufficient cash to purchase new shares — because, for example, they transferred the proceeds from the short sale (e.g., for estate planning reasons). Taxpayers in any of the foregoing circumstances can argue that they have been disadvantaged by their reliance on clearly established law. On the other hand, taxpayers with ample other assets who sold short a liquid stock will find it relatively easy to acquire new shares for closing the short sale. However, considerations of administrability counsel against a rule that attempts to distinguish among taxpayers based on the particular hardship the rule would impose. A more bright-line approach might look to the fact that hedging transactions accomplished by issuing public securities or entering into transactions with financial counterparties typically have a term not more than three to five years. However, a significant number of those involved in the discussion of this report believe that five years of transition relief would be too generous.

VII. Amendments to Section 351's Definition of Investment Company

A. Policy

Under current law a contribution of property to an "investment company" is denied non-recognition treatment under Sections 351 and 721 of the Code.[63] Investment company, for this purpose, is not defined in the Code. Treas. Reg. § 1.351-1(c) provides that a transfer will be considered to be a transfer to an investment company if

> (i) The transfer results, directly or indirectly, in diversification of the transferors' interests, and
>
> (ii) The transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts.

Section 2 of the Bill would amend Section 351(e) of the Code to provide that "[t]he determination of whether a company is an investment company shall be made by taking into account all stock and securities held by the company, whether or not readily marketable." We understand that one class of transactions targeted by

[63] Under Section 351(e) gain or loss is recognized on the transaction. Under Section 721(b) gains but not losses are recognized on contributions to partnership investment companies.

this amendment is the so-called swap fund.[64]

Swap funds structured as partnerships typically keep slightly in excess of 20% of their assets in non-marketable securities, such as privately placed preferred stock (which may be purchased with the proceeds of borrowing by the fund), and the balance of their assets in a diversified portfolio of securities. Under current law taxpayers are able to contribute property, including marketable securities, to swap funds and achieve non-recognition. Thus, current law permits taxpayers in certain circumstances to divest an appreciated position and effectively reinvest in a diversified portfolio of securities; the price of avoiding gain recognition is that 20% of the portfolio must be composed of non-marketable securities. Such arrangements are sufficiently similar to the original swap funds that prompted enactment of sections 351(e) and 721(b) to conclude that these provisions have not achieved their intended effect. We also note that these transactions share a common feature with the constructive sales addressed elsewhere in the Bill — that is, diversification without gain recognition. The question, then, is how to address this area more effectively.

We note that the JCT Report contains a separate proposal targeted at swap funds (the “JCT Proposal”). We are presently studying that proposal and are not yet in a

[64] See Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues, n. 107 (April 8, 1997) (the “JCT Report”).

position to provide a comparison of that approach with the Bill. The JCT Proposal would apply only to a contribution of marketable securities, rather than all assets, and would be triggered if more than 20% of the transferees, assets consisted of marketable securities. In these respects the JCT Proposal is targeted more narrowly at swap funds and more likely to apply (given the 20% threshold) to entities resembling swap funds. For these and possibly other reasons, it is possible that when we complete our review of the JCT Report, we might recommend it as the better approach. If that were the case, we would recommend not enacting section 2 of the Bill, because one of the two measures should be sufficient to address the concerns at issue here.

As an alternative to either of these statutory proposals, swap funds could be addressed by regulation, since the definition of investment company is already entirely based in regulations. Consideration should be given to directing the Secretary to promulgate appropriate regulations designed to address swap funds and other similar arrangements. One advantage of this approach would be that it would provide additional time and a forum in which to consider comments and minimize the possibility of unexpected and unintended consequences of the change. However, unless the legislative directive indicated the intent that the regulations apply to transactions entered into after the date of enactment of the Bill, there would be an “open window” for the establishment of new swap funds.

B. Technical Comments

Set forth below are some of our technical comments on section 2 of the Bill.

1. Current Regulations. We assume that section 2 of the Bill is intended to operate in the context of current regulations. Since these regulations contain certain important provisions without which the Bill would be overbroad, we recommend that legislative history confirm that existing regulations are intended to continue to apply. For example, Treas. Reg. § 1.351-1(c)(4) contains a look- through rule for 50% or more owned subsidiaries. This provision prevents the Bill from applying indiscriminately to holding companies.[65] Given the significance of the changes the Bill would make, we believe it would be appropriate to consider whether 50% remains the proper threshold. For example it is not uncommon, particularly in foreign jurisdictions, for substantial business operations to be held at ownership percentages below 50%, often with effective control secured through contractual or other arrangements. We note, for example, that the provisions of the Code dealing with passive foreign investment companies adopt a 25% threshold for look-through purposes. See Section 1296(c).

[65] Current regulations also provide that the 80% test only applies to assets that are "held for investment," which are defined to exclude stocks and securities held primarily for sale to customers in the ordinary course of business or used in the business of banking, insurance, brokerage, or similar businesses. Treas. Reg. § 1.351-1(c)(1)(ii), (c)(3).

2. Definition of Securities. The current regulations do not define the term “securities.” We note that proposed regulations under Section 368 contain a definition of securities,[66] but it is unclear whether this definition is intended to apply for purposes of the Section 351 and Section 721 investment company rules.

We believe that it would be appropriate to provide a definition of securities, and, further, to grant specific regulatory authority to modify that definition to mitigate over and under-inclusion situations. In the case of over-inclusion, we are concerned that situations may arise in practice where the Bill applies to situations far afield from the abuse targeted in the Bill. Granting specific authority for Treasury to deal with those situations is appropriate from the perspective of administrability.

With respect to under-inclusion, other types of financial instruments or property (such as commodities or net leased real property), which technically do not fall within the ambit of the terms stocks and securities, might nonetheless provide similar opportunities for diversification and risk shifting, and therefore should be covered under the Bill.[67] In particular, we are concerned that the taxing authorities

[66] Prop. Reg. § 1.368-4(c)(5).

[67] We note that the JCT Proposal would take into account actively traded foreign currency, notional principal contracts, derivatives and precious metals.

may end up playing catch-up with sophisticated sponsors of swap funds who devise investments that do not constitute “stocks” or “securities” in which to place 21% of the value of the swap fund’s portfolio. It is this prospect that gives rise to our most serious reservation about the efficacy of the proposed provision.[68]

3. Partnership Interests. The present regulations contain insufficient guidelines concerning whether a partnership interest is a stock or security. Presumably, a 50% or more interest in a partnership would be subject to the look-through rule,[69] but this is not clear. We believe consideration should be given to providing a broader look-through rule for partnerships. Such an approach would be more consistent with recent evolution of the tax law towards viewing partnerships more as aggregates.[70]

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[68] Preliminarily we do not have the same concern about the JCT Proposal, although we need to consider further the implications of retaining marketable securities as the benchmark.

[69] Treas. Reg. § 1.351-1(c)(4).

[70] See, e.g., Reg. § 1.701-2(e). We note that Reg. § 1.368-4(c)(5) addresses the treatment of partnership interests in a different manner.

Appendix A: Text of the Bill

Release Date: February 26, 1997

105th CONGRESS

1st Session

H. R. 846

IN THE HOUSE OF REPRESENTATIVES

February 26, 1997

Mrs. Kennelly of Connecticut introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1986 to require gain recognition in the case of certain transactions that are equivalent to sales of financial instruments, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. CONSTRUCTIVE SALES TREATMENT FOR APPRECIATED FINANCIAL POSITIONS.

(a) In General. — Part IV of subchapter P of chapter 1 of the Internal Revenue Code of 1986 is amended by adding at the end the following new section:

“SEC. 1259. CONSTRUCTIVE SALES TREATMENT FOR APPRECIATED FINANCIAL POSITIONS.

“(a) In General. — If there is a constructive sale of an appreciated financial position —

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

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

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

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

“(b) Appreciated Financial Position. — For purposes of this section —

“(1) In general. — The term ‘appreciated financial position’ means any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold.

“(2) Position. — The term ‘position’ means an interest, including a futures or forward contract, short sale, or option.

“(c) Constructive Sale. — For purposes of this section —

“(1) In general. — A taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) —

“(A) makes a short sale of the same or substantially identical property,

“(B) enters into an offsetting notional principal contract with respect to the same or substantially identical property,

“(C) enters into a futures or forward contract to deliver the same or substantially identical property,

“(D) in the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) with respect to any property, acquires the same or substantially identical property, or

“(E) enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

“(2) Exception for transactions marked to market. — The term ‘constructive sale’ shall not include any transaction if the appreciated financial position which is part of such transaction is marked to market under section 475 or 1256.

“(3) Exception for sales of non-publicly traded property. — The term ‘constructive sale’ shall not include any contract for sale of any stock, debt instrument, or partnership interest which is not a marketable security (as defined in section 453(f)) if the sale occurs within 1 year after the date such contract is entered into.

“(4) Exception for transactions which are closed by year end. — In applying this section, there shall be disregarded —

“(A) any appreciated financial position which is sold or otherwise disposed of during the taxable year in a transaction in which gain or loss is recognized, and

“(B) any other transaction (which would otherwise be treated as a constructive sale) if—

“(i) such transaction is closed before the end of the taxable year, and

“(ii) in the case of a transaction which is closed during the last 30 days of such taxable year, another transaction with substantially the same effect as the closed transaction is not entered into during the 31-day period beginning with the date on which such transaction was closed.

“(5) Related person. — A person is related to another person with respect to a transaction if—

“(A) the relationship is described in section 267 or 707(b), and

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

“(6) Special rule for debt instruments. — For purposes of paragraph (1)(A), positions in interest rates shall be treated as positions in property which are substantially identical to debt instruments.

“(d) Other Definitions. — For purposes of this section —

“(1) Forward contract. — The term ‘forward contract’ includes a fully or partially prepaid forward contract.

“(2) Offsetting notional principal contract. — The term ‘offsetting notional principal contract’ means, with respect to any property, an agreement to pay the investment yield (including appreciation) on such property for a specified period in exchange for the right to be reimbursed for any decline in the value of such property and for other consideration.

“(e) Special Rules. —

“(1) Treatment of subsequent sale of position which was deemed sold. — If—

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

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

“(C) at the time of such sale or disposition, the transaction resulting in the constructive sale of such position is open with respect to the taxpayer or any related person, solely for purposes of determining whether the taxpayer has entered into a constructive sale of any other appreciated financial position held by the taxpayer, the taxpayer shall be treated as entering into such transaction immediately after such sale or other disposition.

“(2) Certain trust instruments treated as stock. — For purposes of this section, an interest in a trust which is actively traded (within the meaning of section 1092(d)(1)) shall be treated as stock.

“(3) Multiple positions in property. — If there is a constructive sale of a portion of any property held by the taxpayer, the determination of the specific property which is deemed sold shall be made in the same manner as if the constructive sale were an actual sale; except that property treated as sold by reason of a prior constructive sale that remains open shall be disregarded.

“(f) Regulations. — The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.”

(b) Securities Traders May Elect Mark to Market. — Subsection (d) of section 475 (relating to mark to market accounting method for dealers in securities) is amended by adding at the end the following new paragraph:

“(4) Securities traders may elect mark to market. — In the case of a person engaged in the trade or business of being an active trader in securities —

“(A) such person may elect to be treated as a dealer in securities for purposes of this section, and

“(B) securities held by such person in connection with such trade or business shall be treated as not held for investment.

Such an election may be made without the consent of the Secretary and, if made, shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary.”

(c) Clerical Amendment. — The table of sections for part IV of subchapter P of chapter 1 of such Code is amended by adding at the end the following new item:

“Sec. 1259. Constructive sales treatment for appreciated financial positions.’

(d) Effective Date. —

(1) In general. — Except as provided in paragraph (3), the amendments made by this section shall apply to —

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

(B) any constructive sale after January 12, 1996, and before the date of the enactment of this Act, but only if, on the date which is 30 days after the date of the enactment of this Act, the taxpayer owns the appreciated financial position subject to the constructive sale and the transaction that resulted in the construction sale remains open with respect to the taxpayer or a related person.

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

(2) Special rule. — In the case of a decedent dying after the date of the enactment of this Act, if –

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

(B) on the day before the date of the decedent’s death, the transaction resulting in the constructive sale of such position is open with respect to the decedent or any related person and gain has not been recognized under section 1259 of the Internal Revenue Code of 1986 (as added by this section), for purposes of such Code, such position (and any property related thereto, as determined under the principles of section 1259(d)(1) of such Code (as so added)) shall be treated as property constituting rights to receive an item of income in respect of a decedent under section 691 of such Code.

(3) Election of Securities Traders to be Treated as Dealers. —

(A) In general. — The amendment made by subsection (b) shall apply to taxable years beginning after the date of the enactment of this Act.

(B) 5-year spread of adjustments. — In the case of a taxpayer who elects under section 475(d)(4) of the Internal Revenue Code of 1986 (as added by this section) to change its method of accounting for its first taxable year beginning after the date of the enactment of this Act, the net amount of the adjustments required to be taken into account by the taxpayer under section 481 of the Internal Revenue Code of 1986 shall be taken into account ratably over the 5-taxable year period beginning with such first taxable year.

SEC. 2. LIMITATION ON EXCEPTION FOR INVESTMENT COMPANIES UNDER SECTION 351.

(a) In General. — Paragraph (1) of section 351 (e) of the Internal Revenue Code of 1986 (relating to exceptions) is amended by adding at the end the following: “The determination of whether a company is an investment company shall be made by taking into account all stock and securities held by the company, whether or not readily marketable.”

(b) Effective Date. — The amendment made by subsection (a) shall apply to transfers after the date of the enactment of this Act in taxable years ending after such date.

Appendix B: Examples

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

2. Portfolio Exchangeable Instrument.

   Taxpayer, a domestic corporation, owns one million shares of common stock of the ABC Corporation (the “ABC Stock”). The ABC Stock represents 20% of the total outstanding common stock of ABC Corporation. The remaining 80% of the ABC common stock is widely-held and publicly-traded. (Accordingly, Taxpayer and ABC are not related parties within the meaning of Section 267(b).) Taxpayer purchased the ABC Stock for $20 per share in

1992 and it is currently trading at $100 per share. The ABC Stock does not pay dividends currently and it is unlikely that any dividends will be paid in the next five years. On January 1, 1997, taxpayer issues one million debt securities (the “Exchangeable Debentures”) to investors (the “Holders”) for cash. Each Exchangeable Debenture is sold for $100 and has a five-year term. During the five-year term, Holders are entitled to semi-annual interest payments of 6% per annum ($6 per debenture). In addition, at the end of the five-year term (the “Maturity Date”), Holders will receive a number (the “Exchange Ratio”) of shares of ABC common stock that is determined based on the trading price of the ABC common stock on the Maturity Date or, at the taxpayer’s option, an amount of cash equal to the value of such ABC common stock. The Exchange Ratio will be determined according to the following schedule:

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

By issuing the Exchangeable Debentures, Taxpayer has eliminated all of its risk of loss with respect to the ABC Stock, since any depredation in the value of the ABC Stock has been shifted to the Holders. For example, if ABC common stock is trading at $80 per share on the Maturity Date, Taxpayer can either deliver one share of its ABC Stock or $80 of cash to retire each Exchangeable Debenture.

Nevertheless, Taxpayer will not be deemed to have made a constructive sale of its ABC Stock unless Taxpayer has entered into a transaction that is substantially the same as one of the four “core cases” described in subsections (c)(1)(A)-(D) of the Bill. The issuance of the Exchangeable Debentures is similar in certain respects to the issuance of a forward contract to sell a fixed number of shares of ABC Stock for a fixed price. However, because the number of shares of ABC Stock (or equivalent value) that will be delivered at maturity of the Exchangeable Debentures is variable, it is appropriate to compare the value of the opportunity for profit that Taxpayer has retained to the value of the total risk of loss and opportunity for profit that exists with respect to the ABC Stock, as determined using options pricing. Taxpayer’s financial advisor has provided the following information regarding the value of certain five-year options on shares of ABC common stock:

Strike Price	Value of Put Option
$100	$21

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

Based on these option prices, the value of 100% of the opportunity for profit with respect to a share of ABC stock over the five-year term of the Exchangeable

Debentures is $35.[71] Moreover, the value of the opportunity for profit that has been retained by Taxpayer with respect to each share during the five-year period is $10 (equal to the excess of the $35 value of all the opportunity for profit above $100 over the $25 value of the opportunity for profit above $115).[72] Thus, the value of the opportunity for profit retained by the taxpayer ($10) represents more than 17% of the sum of the absolute values of the total opportunity for profit ($35) and risk of loss ($21) with respect to the ABC stock over the five-year period (i.e.., 56) Accordingly, Taxpayer has not entered into a constructive sale of the ABC Stock.

3. Out-of-the Money Collars.

A typical "collar" is a hedging transaction whereby a taxpayer hedges a portion of its risk of loss and relinquishes a portion of its opportunity for profit by purchasing an out-of-the-money put option (i.e., one whose strike price is below the current stock price) and selling an out-of-the-money call option (i.e., one whose strike price is above the current stock price).[73] Since

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[71] The value of the taxpayer's right to receive dividends on the ABC Stock during the term of the Exchangeable Debentures is negligible.

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

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

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

In order to determine whether a collar is “wide” enough, it might be possible to use the option pricing approach to quantify the risk and opportunity retained by the taxpayer. In many situations, however, it may be difficult or costly for taxpayers to obtain the required information.[74] Accordingly, consideration should be given to adopting a safe harbor with respect to collars whose “range” includes the current trading price of the security subject to the collar. For example, a safe harbor might apply to any collar that has: (i) a relatively short term (e.g., not exceeding three or, alternatively, five years), (ii) a total “spread” of at least 20% of the current trading price of the hedged security, and (iii) a spread that includes the current trading price of the hedged security.

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

Such a safe harbor would not account for many key factors relevant to the amount of risk and opportunity retained by a taxpayer. For example, such a safe harbor would not consider the volatility of the appreciated security being hedged, the expected current yield (dividends or interest) on the underlying appreciated security, or the term of the hedge (to the extent it is less than three or five years). Accordingly, many collars that do not substantially eliminate the taxpayer’s risk of loss and opportunity for profit with respect to an appreciated security would nevertheless fail to qualify for the safe harbor.[75] On the other hand, the safe harbor has the clear merit of being easy to understand and administer and would seem to protect cases that are adequately distinguished from the core cases targeted by the Proposal. We have not undertaken any quantitative analysis to support the suggested safe harbor, however, and note that it would probably be advisable to limit such a safe harbor to collars that hedge appreciated common stock.

The following example illustrates application of this safe harbor. X, an individual, owns 1,000 shares of stock of HIJ Corporation (the “HIJ Stock”), representing less than one percent of the total outstanding stock of HIJ. X purchased the HIJ Stock for $10 per share on March 1, 1993. The stock of HIJ is widely-held and

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

publicly-traded. On January 1, 1997, at a time when the stock of HIJ is trading at $100 per share, X enters into a transaction with a financial institution whereby X purchases a three-year put option with a strike price of $90 and sells a three-year call option with a strike price of $ 110 (collectively referred to as the "collar"). X receives net proceeds of $8 for entering into the collar since the cost of the put option ($10) is less than the price X receives for selling the call option ($18).

In this example, the put option and the call option are each 10% out-of-the-money (based on the difference between the option's respective strike prices and the trading price of the HIJ Stock at the time the collar is entered into). Collectively, the options reflect a 20% "spread" between the put price and the call price. In addition, the spread of the collar includes the trading price of the HIJ Stock at the time the collar is entered into. Finally, the three-year term of the option will satisfy the safe harbor's maximum term requirement (of three or, alternatively, five years). Accordingly, entering into the collar will not constitute a constructive sale.