New York State Bar Association

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NYSBA

July 14, 1998

The Honorable Barbara B. Kennelly
United States House of Representatives
House Ways & Means Committee
201 Cannon House Office Building
Washington, DC 20515

Dear Congresswoman Kennelly:

Enclosed please find a report of the New York State Bar Association Tax Section, which discusses the "constructive ownership" provisions set out in H.R. 3170 (the "Bill").

The report generally supports the Bill, which should largely prevent the use of "total return" hedge fund derivatives and similar structures that have permitted sophisticated taxpayers to defer tax and effectively recharacterize ordinary income as capital gain. The report does note, however, as we have noted in previous reports, that an incremental approach to the problems associated with the taxation of financial products tends to create more complexity and new technical issues. We continue to urge a more comprehensive review of the taxation of financial products to eliminate inconsistencies in the taxation of economically similar arrangements.

The report expresses a number of concerns regarding the scope of the Bill. In particular, the report explains the difficulties of applying the Bill to transactions which might relate to more than one underlying financial position (each with differing tax treatments), recommends that the Bill not apply to short positions, and suggests that consideration be given to applying the Bill to certain types of transactions only as provided in regulations.

The report also recommends that the elective mark-to-market regime be eliminated in favor of regulatory authority to address this issue. Finally, the report makes a number of technical observations, including identifying an unwarranted loophole with respect to constructive ownership transactions that are terminated without gain recognition, suggesting a modification of the definition of a "forward contract," and recommending provisions designed to ensure that the Bill applies appropriately to certain types of complex financial products.

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

Very truly yours,

Steven C. Todrys
Chair

Enclosure

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

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

Hon. Charles B. Rangel
Ranking Minority Member,
House Ways & Means Committee
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NEW YORK STATE BAR ASSOCIATION TAX SECTION

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COMMENTS ON H.R. 3170

July 14, 1998

Introduction[1]

This report comments on the "constructive ownership" provisions set out in H.R. 3170, as introduced by Rep. Barbara B. Kennelly (D-Ct.) on February 5, 1998 (the "Bill").[2] The Bill targets certain derivative transactions that simulate direct ownership of a financial position but that may result in more favorable tax treatment than direct investment in the underlying position. The derivative transactions in question offer the possible advantages (compared to direct investment in the underlying position) of deferral and transformation of ordinary income or short-term capital gain into long-term capital gain. The Bill would add to the Code a new Section 1260, which would recharacterize a portion of the long-term capital gain on such derivative transactions as short-term capital gain and impose the equivalent of an interest charge on tax deferral. Alternatively, the Bill offers an elective mark-to-market regime.

The Bill is a follow-on to the "constructive sale" regime of Section 1259 of the Code, which was introduced by Rep. Kennelly last year and enacted as part of the Taxpayer Relief Act of 1997. Generally speaking, Section 1259 limits the ability of a taxpayer to *transfer* substantially all of the economic benefits and burdens of ownership of an appreciated financial position the taxpayer holds while deferring the gain recognition that would result from an actual sale. Conversely, the Bill would limit the ability of a taxpayer to *acquire* substantially all of the economic benefits and burdens of ownership of a financial position while deferring and transforming the tax consequences of actual ownership. Not surprisingly, both the vocabulary and general approach used by the Bill to define a "constructive ownership transaction" mirror in many respects those used in Section 1259 to define a "constructive sale."

To review briefly, Section 1259 offers four core cases constituting a constructive sale of an "appreciated financial position" — a short sale against the box, entry into an offsetting notional principal contract, entry into a forward contract to sell the appreciated position, and, in the case of a taxpayer who has an appreciated "short" position, acquisition of an offsetting "long" position. Section 1259 also adds a catchall category for one or more other transactions that have "substantially the same effect" as the enumerated core cases.

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[1] The principal authors of this report are Samuel Dimon, Michael Farber and Kathleen Ferrell. Helpful comments were received from Kim Blanchard, Lucy Farr, Richard Loengard, David Miller, Charles Morgan, Robert Scarborough, David Schizer, Michael Schler, Po Sit and Steven Todrys.

[2] The text of the Bill is attached as Appendix A.

Similarly, proposed Section 1260 defines three core cases that constitute a constructive ownership transaction (hereafter referred to as a "COT") with respect to an underlying "financial position" — holding a long position under a notional principal contract with respect to the underlying position, entering into a forward contract to acquire the underlying position, and holding a call option and granting a put option with respect to the underlying position if the strike prices of the two options are substantially equal. The Bill also uses a catchall category for one or more other transactions that have "substantially the same effect" as the three core cases.

Notwithstanding the parallelism between Section 1259 and proposed Section 1260, they are significantly different in operation. Section 1259 requires gain recognition as if the appreciated financial position were sold or otherwise terminated — a consequence that closely replicates the tax consequences of an actual sale (followed by a repurchase of the position).[3] By contrast, proposed Section 1260 would produce tax consequences which at best roughly approximate the tax consequences of actual ownership of the underlying financial position (the "Underlying"), and, at worst, impose a significant penalty for entering into the COT rather than directly investing in the underlying financial position.

Proposed Section 1260 recharacterizes long-term capital gain from a COT as short-term capital gain to the extent such long-term gain exceeds the "net underlying long-term capital gain," defined as the aggregate net capital gain that the taxpayer would have recognized if the Underlying had been acquired at the inception of the COT and sold on the date the COT closed (taking into account, for this purpose, only gains and losses that would have resulted from the deemed ownership of the Underlying).[4] An addition to tax, in the nature of an interest charge on tax deferral, applies with respect to the amount thus recharacterized as

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[3] While the consequences that apply once Section 1259 is triggered are a relatively precise analog to an actual sale, the scope of transactions to which Section 1259 applies is not precise, nor does the statute apply to all hedging transactions that are economically equivalent to sales. *See generally* Tax Section, New York State Bar Ass'n., Comments on H.R. 846 (May 21, 1997) (expressing concern about the ambiguous scope of the constructive sale regime and requesting prompt guidance; also recommending against the exception for short-term hedging transactions). The ambiguity regarding the scope of Section 1259 relates to when the transfer of the economics of a position goes "too far" and so triggers a constructive sale. Proposed Section 1260 poses comparable line-drawing questions. Regulations interpreting Section 1259 presumably would help clarify certain issues that might be expected to arise under Section 1260.

[4] The Bill would not apply to any COT comprised entirely of positions marked to market under any provision of the Code.

short-term capital gain (the "Recharacterized Gain").[5] The interest charge is computed by applying Section 6601 to the hypothetical underpayment that would have resulted if the Recharacterized Gain had been recognized ratably during the term of the COT. Alternatively, a taxpayer may elect to be subject to a mark-to-market regime. This election (which could not be revoked without the Secretary's consent) would apply to all of the taxpayer's COTs, and would require that all income and loss with respect to such COTs be treated as ordinary in character. As drafted, the Bill would apply to gain recognized with respect to a COT after the date of enactment, without regard to when the COT was entered into.[6]

I. Summary

A. Tax Analysis Under Current Law.

Part II of this Report and Appendix B compare the economics of an investment in a so-called "hedge fund" partnership with the economics of a "total return" derivative with respect to the same hedge fund investment. The economic resemblance is very close, but the current law tax treatment of the two positions is quite dissimilar. Assuming that the hedge fund is profitable, an individual U.S. taxpayer can achieve both deferral and a lower tax rate by entering into the derivative position.

B. Competing Policy Considerations.

In Part III of this Report, we acknowledge the concern prompted by "total return" hedge fund derivatives and agree that it is undesirable to allow such transactions to continue unchecked. We consider it likely, however, based on our experience with Section 1259, that the enactment of the Bill will lead to more complex derivative transactions that offer some but not all of the benefits of the transactions targeted by the Bill. In addition, the Bill comes with the price tag of significant legal complexity.

C. Concern Regarding the Scope of the Bill.

Proposed Section 1260 is brought into play when a taxpayer enters into a COT with respect to a "financial position." While there are numerous technical issues regarding the definition of a COT, we see a more fundamental problem in

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[5] The portion of the long-term capital gain from the COT that is not treated as Recharacterized Gain is taxed "at the rate (or rates) that would have applied to the net underlying long-term capital gain." Proposed Section 1260(a)(2).

[6] The Report does not comment on the effective date provisions of the Bill.

the breadth with which "financial position" is defined. The Bill defines a "financial position" to mean "any position with respect to any stock, debt instrument, partnership interest, or investment trust interest." A "position" is in turn defined (using language borrowed from Section 1259) to mean "an interest, including a futures or forward contract, short sale, or option."

Thus, the Bill applies not only to COTs with respect to stock, debt, etc., but also to COTs with respect to *derivatives* (including short positions) with respect to stock, debt, etc. This raises the potentially unanswerable question of what is the "real" Underlying. We agree that it is desirable to treat economically equivalent transactions consistently, and recognize the problems created in this regard by the proliferation of financial instruments. However, the tax law currently treats economically comparable Underlyings differently, depending on the "cubbyholes" into which they fall. Unless it is possible to identify a unique Underlying (or a unique set of Underlyings) for a COT, there may be potentially conflicting answers to the tax consequences of applying Section 1260.

This "indeterminacy" problem, as well as other scope issues discussed in Part IV, might be mitigated by more narrowly defining the class of "financial positions" covered by Section 1260. For example, Section 1260 could be drafted to target COTs with respect to partnership interests and other specified financial instruments, and to grant authority to the Secretary to promulgate regulations applying the principles of Section 1260 to derivatives with respect to such investments (or other Underlyings), to the extent necessary to prevent significant deferral and/or conversion of ordinary income and short-term gain into long-term gain. As discussed below in Part IV.B, in any event, we do not believe that a short position should constitute a "financial position" for purposes of Section 1260.

D. Issues With Respect to the Interest Charge.

In Part V we discuss the implications of applying the interest charge under the "basic" COT regime only to the extent the long-term capital gain from the COT exceeds the "net underlying long-term capital gain." Such an approach permits deferral of long-term capital gain without an interest charge, and also permits build-up in value attributable to ordinary income to be realized as short-term capital gain. While it can be argued that the regime is too lenient in this regard, we believe that it achieves an appropriate "rough justice." Any attempt to measure and equitably tax the "true" deferral achieved by a COT is likely to be either overly complex or imprecise.

E. Recommendation to Defer Implementation of the Elective Mark-to-Market Regime.

In Part VI we offer reasons for leaving to regulations (or other legislation) the question of the availability and scope of an elective all-ordinary mark-to-market regime. We would be particularly concerned about making such an elective regime immediately available if the Bill is to apply to COTs with respect to stock and debt instruments. Such a regime might skew economic decision-making regarding the form of transactions commonly entered into by both individuals and corporations.

F. Other Technical Issues.

Part VII of this Report identifies a number of other technical issues raised by the Bill. For example, as currently drafted, the Bill does not cover a case in which a COT closes without gain recognition because the taxpayer pays cash to exercise a forward contract or option. While this represents a potential loophole that should be closed, we do not believe that it is necessary or appropriate to treat the purchase as if it were a fully taxable transaction. We discuss two alternative methods of addressing such a situation. We also discuss a number of additional technical issues, including how the Bill should operate in cases in which the taxpayer is simultaneously long with respect to a financial position and short with respect to another financial position (*e.g.*, compound swaps); the treatment of transactions that do not involve a constant Underlying; issues associated with legging into or out of a COT, and a drafting issue regarding the mark-to-market regime (assuming it is not eliminated).

II. Tax Analysis Under Current Law

Under current law, the tax consequences of holding a derivative financial position may differ significantly from those of owning the Underlying, even though the economics of the two positions are nearly identical. Appendix B compares the economic and tax positions of an individual who invests directly in a domestic "hedge fund," organized as a limited partnership, and another individual who enters into a "total return" swap (or another "total return" derivative) with respect to a notional investment in the same fund. In summary, assuming the derivative contract works as intended, the derivative "investor" gains exposure to the economics of owning a partnership interest without accounting each year for the taxable income (or loss) allocable to the partnership interest. Thus, compared with actual ownership of a partnership interest, ownership of the derivative contract permits deferral of current income, if any (which, depending on the facts, might be largely short-term capital gain or ordinary income). In addition, if the derivative contract has a term exceeding twelve months and results in overall gain, the derivative investor is taxed at the long-term capital gain rate.

It might be argued that from a tax policy perspective there is nothing objectionable about these results, so long as the derivative investor's counterparty directly owns the relevant partnership interest and pays federal income tax currently on its allocable share of the partnership's income (if any).[7] In all likelihood, however, the counterparty is a dealer in securities that for federal income tax purposes marks to market both the partnership interest and the derivative contract, resulting in net annual income recognition by the counterparty only with respect to its "spread" on the transaction. Thus, assuming the partnership generates current net income or gain, the transaction results in tax revenue losses. If, on the other hand, the partnership recognizes net losses during the term of the derivative contract, the transaction may increase tax revenues under current law, because the derivative investor cannot claim his economic share of such losses on a current basis. One can reasonably assume, however, that the derivative investor expects the partnership to be profitable. Particularly if he is an individual who can benefit from reduced tax rates on long-term capital gain, a prospective investor has a significant incentive to enter into a derivative contract rather than to invest directly in the partnership.

Beyond tax benefits, derivative contracts enable investors to achieve a degree of leverage that might not otherwise be available on equally favorable terms. Moreover, derivative contracts, rather than separate lending transactions, are often preferred by financial counterparties for various reasons. For instance, such counterparties might achieve a better position with respect to creditor's rights through the derivative transaction, or suffer a less onerous regulatory capital charge, and therefore might be willing to enter into a derivative contract on comparatively favorable terms.

III. Competing Policy Considerations

> [T]he series of *ad hoc* reforms of the taxation of derivatives over the past 15 years [have produced] inconsistent treatment of the two sides of a transaction and inconsistent treatment of economically similar products. Although each of the reforms may have resulted in more accurate

[7] For this reason, one possibility for more precisely defining the scope of the Bill would be to limit its application to transactions entered into with a counterparty that is a securities dealer, a tax-exempt entity or a foreign person.

> measurement of economic income for the particular taxpayers and financial products affected, inconsistencies created by these reforms may have created offsetting welfare losses and/or revenue losses.[8]

This observation is if anything more true today than when written in 1994. The complexity of the tax law is increasing, adding to the burdens of compliance and administration.

The problems associated with incremental, *ad hoc* tax legislation can be seen as an instance of what economists sometimes refer to as the problem of the "second best." As one commentator explains:

> The General Theory of the Second Best deals with the fact that we live in an imperfect, "second best" world, and as a result, the effects of any particular proposal or program on the allocation of resources cannot be judged by evaluating the proposal in isolation. It may very well turn out that a proposal which, by itself, would appear to increase the efficiency of the allocation of resources . . . may, because of its interaction with other imperfect phenomena, produce inefficient results.[9]

In this regard, it may be helpful to consider the Bill's "older brother," Section 1259. We supported the enactment of Section 1259, and still hold that view. There is no good justification for deferring gain recognition when a taxpayer holding appreciated stock enters into a short sale against the box, and permitting sophisticated taxpayers to benefit from such techniques undermines confidence in the tax system.[10] However, the costs incurred in shutting down this transaction were significant. Congress's effort to strike a balance between shutting down short sales against the box (along with economically similar

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[8] Scarborough, *Different Rules for Different Players and Products: The Patchwork Taxation of Derivatives*, 72 TAXES 1031, 1032 (Dec., 1994).

[9] Kleinbard & Evans, *The Role of Mark-to-Market Accounting in a Realization-Based System*, 75 TAXES 788, 791 n.17 (Dec. 1997) (citing Lipsey & Lancaster, *The General Theory of the Second Best*, 24 REV. ECON. STUD. 11 (1956)).

[10] *See, e.g.*, Henriques & Norris, *Rushing Away from Taxes: The Capital Gains Bypass — A Special Report*, N.Y. TIMES, Dec. 1, 1996, at A1.

transactions) and allowing hedging to continue resulted in a complex set of rules. A great deal of energy has been and will continue to be expended to formulate, administer, and understand these rules. The principal upshot of these efforts is that taxpayers who wish to hedge appreciated financial positions do so in a more complex and less complete manner. It is a fair question, then, whether enacting Section 1259 was worth the candle. We believe it was.

Similarly, the Bill targets a strategy for using certain financial products to generate results that seem too good to remain true.[11] We agree with the Bill's sponsor that a legislative response is required. The Bill should largely prevent the use of "total return" hedge fund derivatives (and similar structures) that have permitted sophisticated taxpayers to defer tax and effectively recharacterize ordinary income and short-term capital gain as long-term capital gain. The Bill comes with the price tag of significant legal complexity, however.[12] In addition, we consider it likely, based on our experience with Section 1259, that the enactment of the Bill will lead to more complex derivative transactions that offer some but not all of the benefits of the transactions targeted by the Bill.

IV. Concerns Regarding the Scope of the Bill

A frequently repeated refrain among tax commentators is that mark-to-market accounting is a better measure of income than our current realization-based system. It is not realistic, however, to think that we will move to a full-blown mark-to-market system anytime soon (if ever).[13] It might be argued nonetheless that Section 1260 represents an appropriate step in the direction of mark-to-market, in the sense that it (i) permits elective all-ordinary mark-to-market in lieu of the "basic" COT regime and (ii) requires a taxpayer to recognize

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[11] *See, e.g.*, Browning, *Where There's a Tax Cut, Wall Street Finds a Way*, WALL ST. J., Oct. 21, 1997, at C1.

[12] The incremental level of legal complexity is mitigated somewhat by the overlap between Section 1259 and proposed Section 1260. As the remainder of this Report illustrates, however, Section 1260 presents a host of new complexities.

[13] This is not necessarily a bad thing in a "second best" world. It seems unlikely that we will ever move to a system in which non-traded property is marked to market — if for no other reason than the nightmare of administering such a system. If, however, there is to be a dual system — a mark-to-market regime involving publicly traded property (and properly allocable liabilities?), and a realization-based regime for non-traded property (with an interest charge for deferral?) — many economic decisions, such as whether to make a public offering of stock of a privately held company, may be skewed as a result. Presumably, there would also be greatly increased emphasis on defining and "protecting" the line between publicly traded and non-traded property.

certain types of income in the period to which such income is (very roughly) attributable. It is tempting to think that any step in the direction of marking to market will be a step in the right direction. The "second best" theory counsels caution regarding this conclusion, however. One commentator has recently warned that "applying mark-to-market accounting in a piecemeal and fragmented manner will frequently distort income measurement and produce a situation that is worse than the results under a realization-based model."[14] We share this concern, and as discussed in more detail in Part VI, would either eliminate the Bill's elective mark-to-market regime or defer its implementation pending the promulgation of regulations.

More generally, while the Bill is to be commended for seeking to identify transactions that should be treated similarly to "total return" hedge fund derivatives, we urge caution in enacting a detailed statute based on a theoretical model that reaches beyond problems that have actually been observed or can readily be imagined. Thus, while we agree that "total return" hedge fund derivatives point to a problem that ought to be addressed, we believe, for reasons stated below, that the scope of the Bill should be more precisely drawn, and supplemented with regulatory authority, so as to reduce complexities and the potential for unintended consequences.[15] Part IV.A discusses the ambiguity that results from the Bill's broad definition of "financial position." Part IV.B recommends that the concept of a COT with respect to a short sale be eliminated.

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[14] Kleinbard & Evans, *supra* note 9, at 791. As a particularly relevant example, the availability of mark-to-market treatment for some taxpayers (*i.e.*, securities dealers) but not others has led to the very transactions targeted by the Bill.

[15] We agree that it is desirable (if not always possible under current law) to treat economically similar transactions consistently. Moreover, we recognize that derivatives present a number of issues in this regard that deserve study. We have recently prepared two reports that address this point: *Report on Notional Principal Contract Character and Timing Issues,* 79 TAX NOTES 1303 (June 8, 1998) (the "NPC Report"), and *Report on the Imposition of U.S. Withholding on Substitute and Derivative Dividend Payments Received by Foreign Persons,* 79 TAX NOTES 1749 (June 29, 1998) (the "Withholding Report"). The first of these reports suggests opening a project to study the feasibility of a comprehensive taxing regime for derivatives that would reduce divergent (or, at least, uncertain) tax treatment for economically equivalent financial instruments. The latter report urges caution in applying what are in effect constructive ownership principles in the cross-border withholding context. This is illustrative of our general view that application of constructive ownership principles requires careful analysis of the merits, and appropriate scope, of the underlying regime that is being "protected." We express similar concerns below regarding application of constructive ownership principles to short positions (*see* Part IV.B) and contingent debt instruments (*see* Part IV.C). Without having fully analyzed the question, we also would urge caution in considering other possible extensions of constructive ownership principles beyond those contemplated by the Bill (for instance, to "protect" the regime under Section 514 of the Code applicable to debt-financed income of tax-exempt entities).

Parts IV.C and IV.D discuss issues associated with the application of the COT regime to debt instruments and various categories of stock, respectively.

A. *What is the Underlying?*

The Bill (using language borrowed from Section 1259) broadly defines a "financial position," the Bill's term for an Underlying. A "financial position" includes any "position with respect to any stock, debt instrument, partnership interest, or investment trust interest." A "position" is in turn defined as "an interest, including a futures or forward contract, short sale or option." These broad definitions work reasonably well in the context of Section 1259, where the statute does not operate unless the taxpayer *owns* an *appreciated* financial position — a fact that can be readily ascertained. The same definitions do not work as well in the Bill, where the inquiry is not what the taxpayer *owns* but what the taxpayer should be *deemed to own.* This would make sense if there could be only one Underlying — but that is not the case. As drafted, the Bill applies to COTs (which are, broadly speaking, "total return" derivative positions) with respect to any "position" (defined as an "interest," apparently including any derivative) on any stock, debt instrument, partnership interest, or investment trust interest. Thus, the Bill as drafted applies not only to specified "total return" derivatives with respect to stock, debt, *etc.*, but also to "total return" derivatives *with respect to other derivatives* on stock, debt, *etc.*

This raises the potentially unanswerable question of what is the "real" Underlying. There are numerous ways to gain the same economic exposures — and a variety of applicable tax regimes.[16] Thus, a "total return" notional principal contract ("NPC") on the S&P 500 is an NPC on the underlying stocks, but it might also be characterized as an NPC on an S&P futures contract that generates 60-40 treatment under Section 1256. Under the latter characterization, a long-term capital gain on the NPC could be recharacterized as short-term capital gain and subjected to an interest charge.

Similarly, a total return derivative with respect to a notional investment unit consisting of a debt instrument and a call option is presumably a COT with respect to the two instruments — but might also be viewed as a COT with respect to a single contingent debt instrument. The difference in characterization leads to radically different consequences under proposed Section 1260, in view of the fact that gain recognized by a holder on the taxable disposition of a call option is

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[16] For instance, Appendix C lists various ways in which a taxpayer might achieve exposure to the S&P 500. It may be worth noting in this context that variable life insurance contracts provide much the same economic exposure, and often much the same tax benefits, sought in the total return derivative context.

generally capital in character pursuant to Section 1234, whereas gain on a contingent debt instrument is wholly ordinary pursuant to Treas. Reg. § 1.1275-4 (even if the gain is attributable to the performance of an embedded option).[17] The problem is that the tax law *already* treats economically equivalent positions differently. While it might be worthwhile to address this discontinuity, Section 1260 cannot accomplish that task.

This "indeterminacy" problem could be mitigated by more narrowly defining the class of "financial positions," or Underlyings, to which proposed Section 1260 would apply. For example, one approach would be to include investments in partnerships and other specified financial instruments, but to exclude, unless provided to the contrary in regulations, derivatives with respect to such investments.[18] We do not believe that narrowing the definition of "financial position" in this fashion would permit abuse, so long as the "catchall" category in the definition of a COT is given its appropriate scope and the Secretary is granted authority to apply the principles of Section 1260, retroactively to the effective date of the legislation in appropriate cases,[19] to other transactions to the extent

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[17] The problem is not necessarily solved by providing that Section 1260 will only apply where one can identify an Underlying that "really" exists, as opposed to a hypothetical Underlying. Assume, for instance, that a derivatives dealer has three customers, X, Y, and Z. Customer X wants to acquire a contingent debt instrument, issued by the dealer, with an embedded option on third-party stock. Customer Y wants to achieve the same economic return by acquiring debt of the dealer and a european-style call option (*i.e.*, exercisable only at maturity) written by the dealer. Customer Z wants to enter into a "total return" derivative with the dealer and (prior to talking with his tax lawyer) is indifferent whether the notional Underlying is the contingent debt instrument or the debt plus the warrant. It would seem that the contingent debt should be viewed as "substantially identical" to the debt-warrant package, and *vice versa*. It would be curious, in the context of legislation that emphasizes substance over form, to conclude that in such a case the manner in which the Underlying is described in the COT document would radically change the tax consequences to Customer Z.

[18] For reasons discussed in Part IV.C below, we have a number of reservations about applying Section 1260, in its current form, to debt instruments. Similarly, as discussed in Part IV.D, we believe that limitations on the application of Section 1260 to COTs with respect to stock should be considered.

[19] For example, the legislative history might refer to the following transaction (which we believe should be a COT but which would not constitute one of the enumerated COTs if Congress accepts our proposed narrowing of the definition of a "financial position"), as an example of a transaction to which regulations would be expected to apply retroactively to the effective date of the legislation: Suppose that a dealer acquires a hedge fund interest and sells such interest forward to another dealer, which sells such forward contract forward to an individual taxpayer. We believe that this "forward contract on a forward contract" held by the taxpayer clearly should be a COT under the catchall provision, and that assuming the forward held by the taxpayer has (continued...)

necessary to prevent significant deferral and/or character conversion.[20] If, however, the current definition of "financial position" is generally retained, we recommend (for reasons discussed below in Part IV.B) that the reference to "short sale" in the definition of "position" be eliminated.

B. *Short Positions.*

Discontinuities exist in the treatment of gain realized on the closing or assignment of various positions that are economic "shorts." In some cases, such gain is treated as short-term capital gain without regard to the period during which the position was held open, whereas other, economically similar transactions would seem to permit realization of long-term capital gain. Thus, for instance, Section 1233(b)(1) provides that gain on the closing of a short sale is short-term capital gain (without regard to the period during which the short sale is open) if, on the date of the short sale, substantially identical property has been held by the taxpayer for not more than 1 year, *or* if substantially identical property is acquired by the taxpayer after entry into the short sale but prior to its closing. On the other hand, gain on the termination or assignment of an NPC is presumably long-term if the taxpayer has held the NPC position for more than one year, without regard to whether the taxpayer holds the "long" or "short" side of the NPC.

While it might be reasonable to treat these economically similar transactions similarly, Section 1260 does not provide the mechanism for achieving this result. Assume, for example, that an individual taxpayer enters into the "short" side of an NPC with respect to stock that closes after more than 12 months, resulting in gain that (apart from Section 1260) is treated as long-term capital gain. If the NPC is treated as a COT with respect to an actual short sale of the stock, the long-term capital gain would presumably be recharacterized as short-term capital gain and subjected to an interest charge. This is *not* economically comparable to the treatment that would have applied if the taxpayer had actually entered into the short sale, since the tax law governing short sales permits deferral (whereas the interest charge under Section 1260 is based on a

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[19] (...continued)
total return economics, such a transaction should be viewed as an appropriate case for retroactive application of regulations.

[20] Alternatively, Section 1260 could be drafted more along the lines of Section 7701(*l*) as a grant of regulatory authority to apply conduit principles to COTs, or otherwise to prescribe regulations to prevent deferral and transformation of ordinary income or short-term gain into long-term gain where taxpayers have entered into derivative transactions that simulate direct ownership of a financial position. Transactions already identified as appropriate targets of Section 1260 could be described in the legislative history as a source of direction for the regulations project.

"rough justice" premise that income should be treated as if it had been recognized ratably over the term of the COT).[21]

More fundamentally, we believe that before attempting to conform the treatment of "short" COTs to the treatment of short sales, Congress should consider which of these treatments is more appropriate. Section 1233(b) is intended to prevent a taxpayer from "aging" a capital asset for the long-term holding period, without economic risk, before disposing of that asset — an abuse that has largely been short-circuited by the subsequently enacted straddle rules. Section 1233(b) arguably should not — indeed, arguably does not — apply at all to the closing of a "naked" short position with a cash payment (*i.e.,* where the "short" taxpayer never holds the underlying capital asset).[22] Instead, such a speculative short position arguably should give rise to long-term capital gain if the taxpayer holds its position open for more than one year. In any event, we believe that this issue should be studied separately (together with the question whether gain on lapse or termination of a written option should always be short-term, as required by Section 1234(b)).

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[21] As a drafting matter, moreover, Section 1260 clearly contemplates an Underlying that is an asset rather than a short sale. Section 1260(d) refers to "long positions" and contracts to acquire "the same or substantially identical property." There is no "property" that is substantially identical to a short sale. In addition, the Bill would treat the taxpayer as if the Underlying had been "acquired" when the COT was entered into and "sold" when the COT was closed. One can neither acquire nor sell a short sale. If the Bill is to apply to short positions, technical clarifications are needed.

[22] *See* I.T. 3721, 1945 C.B. 164 (gain on the assignment of a contract to sell stock on a "when-issued" basis is long-term if the contract has been held for the long-term holding period); *cf.* Gen. Couns. Mem. 37332 (Nov. 25, 1977) (styled as the "Republication of I.T. 3721") (cites legislative history of Section 1233 indicating that a forward sale of when-issued stock constitutes a short sale and the assignment of such contract constitutes the closing of such short sale; the GCM nonetheless implies that the short-term loss rule applies only if the taxpayer acquires the stock or substantially identical property prior to assigning the contract to sell); *cf. American Home Prods. Corp. v. United States,* 601 F.2d 540 (Ct. Cl. 1979) (taxpayer entered into a contract to sell British pounds at a time when it did not own British pounds; assuming *arguendo* that the contract was a commodity futures contract, the court held that assignment of the contract to a third party in exchange for cash produced long-term capital gain not subject to Section 1233(b) because the taxpayer had not held or acquired "substantially identical property," which the court viewed as "an essential part of the statutory scheme"); *The Carborundum Co. v. Comm'r,* 74 T.C. 730 (1980) (holding for taxpayer on facts similar to those of *American Home Prods.,), acq.,* 1984-2 C.B. 1.

C. *Debt Instruments.*

We believe that the policy reflected in the Bill — that a derivative that is the economic equivalent of ownership should not enjoy significantly better tax treatment than actual ownership of the Underlying — applies with particular force to certain transactions with respect to debt instruments. However, we question whether the Bill is the appropriate means to deal with these troublesome transactions. As illustrated by the examples discussed below, application of the COT regime to debt instruments may produce results that differ inappropriately (either favorably or unfavorably to the taxpayer) from the taxation of the Underlying. Accordingly, we believe that application of constructive ownership concepts to debt instruments deserves further study and recommend that Congress consider making the COT regime applicable to debt instruments only to the extent provided in regulations.[23]

A good argument can be made for the application of Section 1260 to "total-return" derivatives with respect to debt instruments in certain cases (although technical amendments to the Bill would be necessary to produce the appropriate character and timing results). For example, consider a taxpayer who enters into a cash-settled forward contract to buy, two years after the contract date, a high-yield zero-coupon bond with a maturity date substantially later than the contract maturity date. At the inception of the forward contract, the fair market value and adjusted issue price of the bond both equal \$100; after two years its adjusted issue price will be \$120. The forward price is \$112.[24] Assume that when the forward contract settles, the bond is in fact worth \$120, resulting in \$8 of long-term capital gain for the taxpayer. Section 1260 would recharacterize the gain as short-term capital gain, and the retroactive underpayment interest charge would apply. If the COT regime applies,[25] the gain should be recharacterized as

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[23] The extent, if any, to which the regulations should apply retroactively to the effective date of the legislation is a topic that could be addressed in legislative history. This approach was followed with respect to the application of the catchall provision of Section 1259 to collars. Also, for example, the legislative history of Section 246(c)(4)(C) provided very specific examples of transactions that Congress intended to be addressed retroactively in regulations that were otherwise to apply prospectively.

[24] The \$12 difference between the value of the bond at inception of the forward contract and the forward price is attributable to the risk-free time value of the \$100. The difference between the forward price in two years and the adjusted issue price of the bond at that time is attributable to the difference between the risk-free interest rate and the high-yield interest rate that the bond's issuer must pay.

[25] It is not entirely clear to us that the COT regime should apply in the case described in (continued...)

ordinary income, and the interest charge should be based on applying constant-yield principles as opposed to ratable allocation of the gain.[26]

Another troublesome category is prepaid forward contracts (or deep-in-the-money options) to acquire debt instruments in circumstances where the time value of the up-front payment may not be accounted for under current law. We believe that the Treasury has relatively broad regulatory authority under Section 446 to issue regulations imputing interest income with respect to substantial up-front payments on certain types of prepaid forward contracts and deep-in-the-money options (including those with respect to both debt and equity, and those that lack "total return" economics).[27] We understand that this topic has been considered by the IRS and Treasury from time to time over a number of years, but there does not appear to be any imminent regulatory action. Part of the problem in arriving at a satisfactory regulatory regime apparently relates to a "line-drawing" issue: namely, differentiating between "normal" option premiums (where the non-imputation of interest is quite well-established, though not beyond question as a conceptual matter) and "substantial" up-front payments. Although this is not an easy topic, we believe that it should be pursued further. In the meantime, it is debatable whether it is worth trying to solve the problems associated with prepayments in the limited case of total-return derivatives subject to Section 1260.

A more complicated set of issues exists with respect to COTs where the Underlying is contingent debt subject to the rules of Treas. Reg. § 1.1275-4. It can be argued that such COTs should be immediately subject to Section 1260, because any other approach would permit circumvention of the "all ordinary"

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[25] (...continued)
the text. Suppose, for the sake of argument, that the bond in question does not exist, and that the forward contract is with the issuer. The taxpayer is not then getting a "better" result by entering into a derivative contract; he is simply contracting to buy debt at a discount in the future. It would not seem appropriate to apply the COT regime in such a context (even if the bond had terms comparable to a bond of the issuer that was outstanding at the time the forward contract was entered into). Assuming that this point is accepted, it can be questioned why the taxpayer should have a worse result because of entering into the COT transaction with a party other than the issuer of the debt. The response might be that Section 1260 should apply when taxpayers are entering into what amount to conduit arrangements, where intermediation by a dealer or other party allows the taxpayer to achieve better tax results.

[26] The principles applicable to a contract to acquire a zero-coupon bond might apply equally to a contract to acquire a high-yield coupon-paying bond.

[27] *Cf.* Treas. Reg. § 1.446-3(g)(4) (treating "significant" up-front payments with respect to NPCs as embedded loans on which interest is imputed).

regime of the contingent debt regulations. However, as noted above in Part IV.A, the "all ordinary" approach of the contingent debt regulations is itself a source of discontinuity in the tax law. In many cases, the economics of a contingent debt instrument could be recreated using an investment unit the components of which would give rise to capital gain or loss on disposition. If the Bill is enacted in its current form, there will be a need to determine whether COTs with respect to such investment units should be treated as COTs with respect to property "substantially identical" to contingent debt. If, however, the underlying problem is the "all ordinary" approach of the contingent debt regime — and a reasonable argument can be made that this is the case — it would not seem productive to use the COT rules to "protect" the contingent debt rules. We would therefore suggest that whether to apply the principles of Section 1260 to COTs with respect to contingent debt is a question better dealt with in regulations, and that if Section 1260 is applied to such transactions, consideration should be given to treating the Recharacterized Gain as ordinary income and applying the noncontingent bond method of Treasury Regulations Section 1.1275-4 to allocate the Recharacterized Gain for purposes of determining the interest charge.

In addition to producing the anomalous character and timing results noted above, Section 1260 as drafted creates an inappropriate discontinuity with the market discount rules. For example, assume that a taxpayer enters into a two-year, total-return "long" NPC with respect to debt trading at a substantial discount to its adjusted issue price (a "market discount bond" within the meaning of Section 1276 of the Code). If at the end of two years the debt has appreciated in value, the taxpayer presumably will have long-term capital gain on the closing of the NPC (prior to any application of Section 1260).[28] If, on the other hand, the taxpayer had acquired the market discount bond at the inception of the NPC and sold it at the maturity of the NPC, some of the gain recognized would have been recharacterized as ordinary income pursuant to Section 1276 of the Code (assuming the taxpayer had not elected to include the market discount in income using a constant-yield method), but there would have been no current income inclusions with respect to the market discount during the period the taxpayer held the bond (or interest charge for deferral).

There are certain types of transactions with respect to debt to which we do not believe Section 1260 should apply at all. Consider the case of a taxpayer who

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[28] As noted in Appendix B (notes 2-3 and accompanying text), while there is some question whether gain on the receipt of a contingent non-periodic payment at the maturity of an NPC is capital or ordinary in character, the issue is largely academic, because it is quite clear that gain on the termination of the NPC *prior* to its maturity is capital. (It is precisely because of the latter point that gain on the maturity payment should also be capital; otherwise, Treasury will be exposed to the kind of whipsaw Section 1234A was enacted to prevent.)

enters into a five-year, total-return "long" NPC with respect to a floating-rate bond that, at inception of the NPC, has a fair market value equal to its par value and a remaining term to maturity substantially in excess of five years. On a periodic basis, the taxpayer pays a fixed rate of interest and receives the bond's floating rate, and at maturity of the NPC the taxpayer receives a payment if the bond has appreciated in value, or makes a payment if the bond has declined in value.[29] Assume that after more than one year, at a time when interest rates have risen (but the fair market value of the bond has not changed) the taxpayer agrees to terminate the swap in exchange for a payment of $10 (which under current law would be treated as long-term capital gain). Section 1260 as currently drafted apparently would apply because no capital gain would have resulted if the floating rate bond had been purchased and sold at par. Thus, the taxpayer would be subject to a retroactive underpayment interest charge with respect to the $10 of gain. We think this is inappropriate, because the taxpayer's gain is attributable to a change in interest rates which has no particular relationship to any change in the value of the bond. The taxpayer would have had the same long-term capital gain if he had entered into a plain-vanilla fixed-for-floating interest rate swap.[30]

At bottom, we are not certain that the policy concerns that are implicated by derivative transactions with respect to debt instruments are the same policy concerns that are raised by "total return" swaps with respect to hedge funds. As discussed above, the issues raised by prepayment transactions, while important, are not limited to COTs and should be dealt with more comprehensively. Concerns regarding the use of COTs to avoid contingent debt treatment may be valid, but the application of proposed Section 1260 to such instruments is complicated by the existing discontinuity in treatment of economically similar Underlyings. Finally, it would appear to us that many of the potential "abuses" involving derivatives with respect to debt instruments relate not to the replication of total return economics without current inclusions but to the conversion of what

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[29] A change in the bond's value might be attributable to a change in the issuer's credit rating, for instance.

[30] It could be argued that a taxpayer who enters into a fixed-for-floating interest rate swap is like the issuer of fixed-rate debt and should recognize ordinary income (based on an analogy to "cancellation of indebtedness" income) if it terminates the swap at a gain. In rebuttal, it can be observed that such a taxpayer is not in fact a debtor, and that there is no particular reason to favor the fixed or floating payor in an interest-rate swap insofar as qualification for long-term capital gain is concerned. It should also be noted that if, instead of entering into the NPC, the taxpayer had actually purchased the floating-rate bond and simultaneously entered into a fixed-for-floating swap with the same maturity as a the bond, the taxpayer could presumably have elected to apply the integration regime under Treas. Reg. § 1.1275-6. In that case, the taxpayer would have been treated as acquiring a fixed-rate bond and would have had long-term capital gain if both positions were terminated after one year.

is effectively a time value of money return into long-term capital gain — a result that Section 1258 is intended to prevent. We therefore recommend caution in considering the application of Section 1260, in the first instance, to COTs with respect to debt instruments.

D. *Stock.*

For reasons discussed below, we conclude that: (1) application of the COT regime to stock of passive foreign investment companies ("PFICs") generally produces reasonable results; (2) application of the COT regime to stock of regulated investment companies ("RICs") and other pass-through entities is appropriate in concept, but will require definitional changes to produce appropriate results; and (3) consideration should be given to deferring the general application of the COT regime with respect to stock of subchapter C corporations until regulations are promulgated, although we recognize the potential to use derivatives with respect to stock to achieve deferral and conversion in connection with dividend "roll-up" and investment-averaging strategies.

1. *PFICs.* The PFIC and COT regimes are conceptually similar. Each is a response to a paradigm situation where (prior to implementation of the regime) an investor could participate in the buildup in value of a portfolio of investments without the investor (or the fund itself) bearing the tax burden that would have resulted if the investor directly owned and traded the underlying portfolio assets. Each regime aims to curtail an investor's ability to achieve deferral and (to the extent income is recognized) taxation at favorable capital gains rates. Accordingly, each regime limits the investor's ability to claim long-term capital gains, and each uses a look-back method of imputing income and a corresponding interest charge. Each also has an "all-ordinary" mark-to-market election, although the elective regime for PFIC shareholders is limited in scope.[31]

That said, certain differences between the two regimes should be noted. The PFIC regime (1) imposes "all ordinary" treatment for *all* income,[32] in contrast to Section 1260's more limited recharacterization of only a portion of the investor's income as short-term capital gain; (2) imposes a "look-back" interest charge on "excess distributions," defined to include *all* gain on dispositions of

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[31] *See* Section 1296.

[32] Section 1291(a)(1).

PFIC stock;[33] (3) denies the benefit of stepped-up basis at death for PFIC stock;[34] and (4) provides regulatory authority to treat an option to acquire PFIC stock as if it were PFIC stock.[35] As an alternative to this harsh treatment, PFIC shareholders are offered an elective "qualified electing fund" ("QEF") regime,[36] which requires flow-through treatment of current income of the QEF but preserves long-term capital gain treatment with respect to the shareholder's *pro rata* share of the net long-term capital gain of the fund. The QEF election is not available to the holder of an option to acquire PFIC stock.[37]

The similarities and differences between Section 1260 and the PFIC regime are a useful source of insight into, and questions regarding, each regime. For instance, the "all ordinary" approach of the basic PFIC regime looks harsh in this light — although it is mitigated by the availability of the QEF election. The treatment of options under the PFIC regime is particularly punitive, in view of the absence of an available QEF election.[38]

One might also ask why the COT regime does not allow an analog to the QEF election — or perhaps a more complete "conduit" election, pursuant to which the holder of the COT and a dealer counterparty could both agree to treat the COT holder as owner of the Underlying (subject to a financing arrangement,

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[33] Section 1291(a)(2). Interestingly, the "look-back" interest charge does not apply to recharacterized gain allocated to periods prior to the effective date of the provision. As drafted, proposed Section 1260 would produce a harsher result in this respect.

[34] Section 1291(e).

[35] Section 1298(a)(4). Proposed regulations treating an optionholder as a shareholder of the PFIC (Prop. Treas. Reg. § 1.1291-1(d)) were issued in April 1992 but have never been finalized. Under the proposed rules, exercise of an option to acquire PFIC stock is not treated as a disposition of the option; instead, the shareholder is treated as having held the PFIC stock during the term it held the option. *See* Prop. Treas. Reg. § 1.1291-1(h)(3).

[36] Sections 1293-1295.

[37] Treas. Reg. § 1.1295-1T(d)(4). The preamble to the 1997 temporary QEF regulations explains that the QEF election was not made available to the holder of an option on PFIC stock because it "would present serious computational issues and would be administratively burdensome." Presumably, the computational issues include the need to allocate income and gain of the PFIC between the option holder and the actual holder of the stock in the PFIC. *See* T.D. 8750, 63 Fed. Reg. 6 (Jan. 2, 1998).

[38] An argument could be made for explicitly extending the application of Section 1260 to options to acquire PFIC stock (even though options are not generally subject to Section 1260) and revoking the PFIC option rules.

in the case of a "leveraged" COT) and to treat the dealer as earning only ordinary income (presumably on a mark-to-market basis) with respect to its offsetting positions. The principal arguments against such a regime would be complexity and the general problems of allowing electivity.[39] In any event, we can foresee no harm if such a regime were permitted, or (perhaps more appropriately) required, to the extent provided in regulations.[40]

2. ***RICs.***[41] It is not difficult to imagine a "total return" derivative transaction with respect to stock of a RIC that (under present law) presents the same advantages as a COT with respect to a hedge fund. Thus, the taxpayer could enter into an NPC, forward, or put/call combination with respect to X shares of stock of a RIC pursuant to which, at maturity of the contract, the taxpayer would "owe" a substantially fixed amount and the counterparty would "owe" a variable amount equal to the then value of X shares *plus* the number of additional shares that could have been purchased by immediate reinvestment of the dividends paid by the RIC during the term of the COT.[42] Section 1260 should address such a "dividend roll-up" transaction, but it is not clear that it does. If structured as a forward contract, for instance, this arrangement would not provide for the delivery of (or cash settlement with reference to) "a substantially fixed

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[39] Complexities of such an approach would include the need for mechanics to deal with the imbedded loan element in a "leveraged" COT and policy choices regarding application of other regimes generally applicable to financing costs (e.g., investment interest limitations). Such an approach might be most appropriate for cases in which the counterparty is likely to hold the Underlying, and should be limited to determining timing and holding periods (not, for example, eligibility for the dividends received deduction, or character as tax-exempt income).

[40] If such a "conduit" regime were implemented (whether on an elective or mandatory basis), a deemed owner of PFIC stock should be permitted to make a QEF election if the generally applicable conditions for a QEF election were satisfied.

[41] The comments that follow with respect to RIC COTs are also applicable, for instance, to COTs with respect to REIT COTs.

[42] Assume, for instance, that (1) the initial value of a RIC share was \$100, (2) the term of the RIC was slightly over a year, and (3) shortly before the maturity of the contract, the RIC paid a dividend of \$12 a share, immediately following which the value of a single share was \$120. Reinvestment of the \$12 dividend would buy one-tenth of a share, so that at maturity of the COT the taxpayer would "owe" a fixed amount (*e.g.*, \$106X, representing the initial value of X shares plus an interest factor), which would be netted against the then value of a share (\$120) multiplied by 1.1X (the initial notional number of shares, X, increased by the deemed reinvestment of the dividend to purchase .1X shares). If the \$12-per-share dividend paid by the RIC was not a "capital gain dividend," this COT would permit the taxpayer to achieve deferral while effectively converting a portion of what would otherwise be ordinary income into long-term capital gain.

amount of property for a substantially fixed price."[43] This arrangement arguably should be covered by the catchall provision of Section 1260(d)(1)(D), but it seems advisable to clarify the issue.[44]

3. ***Subchapter C Corporations.***[45] COTs with respect to stock of Subchapter C corporations ("SubC stock") typically offer little tax "juice" because SubC stock already represents an attractive investment, in light of the opportunity to defer realization and, in the case of individual investors, enjoy the benefit of preferential long-term capital gain rates. A few qualifications to this observation should be noted, however.

First, to the extent that the investor prepays with respect to a forward contract on SubC stock, it is possible to effect a "roll-up" of dividend income that can be realized at long-term capital gain rates.[46] As observed above in Part IV.C, the accounting for the time value of up-front payments on derivatives should be addressed on a global basis (not only with respect to COTs).[47] It also should be noted that common SubC stock typically pays relatively low dividends, making the concept of a dividend roll-up one of limited interest. A prepaid dividend roll-up strategy with respect to preferred SubC stock would be more troublesome.[48] Generally speaking, whatever approach is taken with respect to prepaid debt COTs should probably also apply to prepaid equity COTs, especially if the Underlying is preferred stock.

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[43] The quoted language is from the definition of forward contract in Section 1259(d)(1), which is incorporated by reference by proposed Section 1260(d)(4).

[44] The point could be addressed in legislative history. Our suggestions for resolving this issue are discussed in Part VII.D.

[45] We use the term "Subchapter C corporation" to refer to domestic and "regular" foreign corporations.

[46] The discussion above regarding RICs provides an example of a dividend roll-up. *See* notes 41-44 and accompanying text.

[47] This does not, however, preclude the use of Section 1260 to serve a "stopgap" function, insofar as prepaid COTs are concerned, pending the development of a more-comprehensive regime addressing the prepayment issue. If Congress intends for Section 1260 to serve such a stopgap purpose, it could so indicate in legislative history.

[48] Note that if a preferred dividend roll-up produces a substantially fixed return, the resulting gain might be ordinary income pursuant to Section 1258. In such a case, there would be no occasion to apply Section 1260. The same observation is true for prepaid COTs with respect to debt.

A second troublesome type of derivative with respect to SubC stock (as well as, for instance, interests in hedge funds) mimics an "investment-averaging" strategy. For instance, a taxpayer could agree on January 1, 1999 to pay $124 on January 30, 2000 for delivery (or cash settlement) of a number of shares of XYZ stock representing the results of investing $10 at the end of each month in 1999 in such stock.[49] Assuming that the stock appreciates during this period, the investor could claim long-term capital gain, even though all such gain would have been short-term if the taxpayer had made the underlying investments.[50] As currently drafted, Section 1260 is not clearly applicable to such an instrument, because it does not involve delivery of a substantially fixed amount of property. In Part VII.D we suggest drafting changes to make clear that an investment-averaging derivative would constitute a COT, reflecting our view that such a derivative should not escape the Section 1260 net. We question, however, whether such a derivative with respect to SubC stock would in fact generate significant investor interest unless the investor prepays its side of the contract.[51]

There are circumstances where the application of Section 1260 to COTs with respect to SubC stock produces questionable results. For instance, assume that on June 30, 1999, a taxpayer enters into an 18-month COT with respect to stock of X Co., and that, during the first half of the year 2000, X Co. is the subject of a fully taxable acquisition at a substantial premium, pursuant to which X Co. shareholders receive noncash proceeds (*e.g.*, stock and warrants of the acquiror). Assume that the COT by its terms does not terminate but provides that the amount the counterparty "owes" at maturity (to be netted against the amount "owed" by the taxpayer) is determined by reference to the value, at maturity of the COT, of the consideration received by X Co. shareholders in connection with the

[49] The difference between the $120 invested and the taxpayer's $124 payment represents the time value of money. Dividends with respect to the notional investment in XYZ stock would also be "notionally" reinvested.

[50] Extending the term of the transaction does not produce predictably "better" tax results, in terms of converting what ought to be short-term capital gain into long-term capital gain (unless the investor prepays its side of the contract), because the gain on any "notional" investment would in any event have constituted long-term capital gain if the term of the contract extends more than one year beyond the date of such "notional " investment. Thus, if the taxpayer had actually made the monthly investments over a period of, say, 14 months, the sale of the "first" $10 investment would have produced long-term capital gain.

[51] Most investors would probably prefer an actual investment-averaging strategy, which (1) produces maximum flexibility regarding the timing and amounts of investments and (2) generally results in lower transaction costs than a privately negotiated contract. By contrast, we would anticipate considerable interest in an "investment-averaging" derivative with respect to hedge funds, assuming Section 1260 were enacted in its current form.

acquisition (*i.e.*, the stock and warrants issued by the acquiror).[52] The interest-charge rule seems harsh in this case. First, the deficiency interest rate is somewhat punitive (about which more in Part V). Second, the taxpayer has not achieved any deferral, since all the income would be realized in the year 2000 whether the taxpayer entered into the "physical" or derivative position.[53]

There are numerous other examples of situations where the application of Section 1260 to SubC stock would produce results that are unclear (and potentially harsh). To list several, without attempting to fully analyze the appropriate result:

- X Co., whose stock is trading at $100, announces a plan to effect a tax-free spinoff of a subsidiary a minority interest in which is already publicly traded. Shortly thereafter, Taxpayer enters into a forward contract to acquire stock of X Co. for $50 in 18 months (*after* the spinoff date). How should the net underlying long-term capital gain be calculated?

- Assume that a publicly offered equity derivative does not constitute a COT at the time it is issued, because the number of shares that will be delivered at maturity of the derivative is not substantially fixed.[54] After 18 months, the price of the Underlying

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[52] Although the question is not entirely free from doubt, we have assumed for purposes of this discussion that the acquisition of X Co. does not give rise to a deemed taxable termination of the COT. *Cf.* Treas. Reg. § 1.1001-3(c) (modification of debt instruments pursuant to their terms generally does not give rise to a constructive exchange).

[53] One possible resolution of the latter issue would be to allow the taxpayer to prove, by clear and convincing evidence, the timing of all income (not simply "net underlying long-term capital gain") that would have been realized if the Underlying had been bought at the inception of the COT and sold at the termination of the COT. The Recharacterized Gain might then be allocated in a manner that appropriately reflects the benefit of deferral with respect to non-long-term capital gain income attributable to the Underlying. Such an approach has the potential for introducing considerable complexity, though, particularly if the Underlying is a partnership (given that losses as well as gains pass through to partners). If this approach is to be permitted, implementation should be left to regulations. A good argument can be made that any move in this direction should go further and implement an elective or mandatory "conduit" regime along the lines discussed above at notes 39-40 and accompanying text. We recognize that such a regime raises a number of potentially complex issues, consideration of which is beyond the scope of this Report.

[54] For instance, assume that the Underlying stock is trading at $100 when the derivative is issued. The derivative gives the holder the right to receive, in three years, (i) a full share if the

(continued...)

stock has quadrupled in value, and as a result it can be argued that the amount of Underlying stock that will be delivered at maturity of the derivative has become substantially fixed. Should a taxpayer who purchases the derivative in the secondary market be viewed as entering into a COT?

- Bankrupt company X proposes a plan of reorganization pursuant to which creditors will receive stock. After the plan is confirmed, but prior to its effective date, Taxpayer buys the claims of a creditor. Does this constitute entry into a COT, and if so, how should the net underlying long-term capital gain be calculated?

- Taxpayer enters into a 2-year total-return swap on the S&P 500 pursuant to which taxpayer pays an interest factor periodically (and the counterparty pays the "dividend yield equivalent" on the S&P 500). A payment based on the appreciation or depreciation of the index is due at maturity of the swap. During the first year of the swap, one of the companies comprising the S&P 500 is acquired pursuant to an all-cash tender offer. Does this result in an interest charge?[55]

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[54] (...continued)
value of the Underlying at such time is less than or equal to $100, (ii) a fractional share worth $100 if the value of the Underlying at such time is between $100 and $120, and (iii) 5/6 of a share if the value of the Underlying at such time exceeds $120.

[55] Whether Section 1260 would impose an interest charge in such a situation generally would depend on whether the net periodic swap payments made by the taxpayer are fully deductible. In a recent report, we recommended consideration of two alternative timing regimes for contingent payment NPCs, adoption of either of which would reduce the amount of gain subject to the application of the Bill. One regime would deny current deductions for periodic payments, requiring that they be deferred and offset against the final contingent payment. Under this regime, ordinary income in each year of the NPC would be increased by the amount of the disallowed deductions, and the amount of gain subject to Section 1260 on the maturity or termination of the NPC would be the excess of the final contingent payment over the deferred periodic payments. The other regime would allow current deductions for periodic payments, but would require current accrual of ordinary income based on the "projected amount" of the final contingent payment. The amount of gain that would be taken into account on final settlement (and which, therefore, may be subject to proposed Section 1260) would be the excess, if any, of the final contingent payment over its projected amount. We note that proposed Section 1260 produces an appropriate result when overlaid on either of these regimes, because the effect of deferring periodic ordinary deductions or imputing periodic ordinary income is to increase the taxpayer's current ordinary inclusions during the term of the NPC, which is consistent with the intended consequence of proposed Section 1260. If the "all-ordinary" proposal in our NPC Report is adopted, there would be no occasion to apply Section 1260.

While it may be possible to develop satisfactory applications of Section 1260 in all of the foregoing situations, this would be a more appropriate task for regulations. If, pending the promulgation of regulations, Section 1260 is by its terms applicable to all COTs with respect to Sub C stock, it is predictable (given the size of the equity derivatives market in this country) that there will be a substantial amount of effort devoted to considering such questions. One approach that could be considered would be to defer application of Section 1260 to COTs with respect to Sub C stock generally, pending the promulgation of regulations, while using the legislative history of Section 1260 to provide guidance regarding transactions to which the regulations should apply retroactively to the effective date of the legislation.

V. Issues With Respect to the Interest Charge

In limited circumstances, the interest charge under the "basic" COT regime (which applies only to the extent the long-term capital gain from the COT exceeds the "net underlying long-term capital gain") permits potentially significant deferral without an interest charge. The problematic cases are ones where the Underlying is an investment partnership or regulated investment company that produces mostly long-term capital gain. While it can be argued that the interest charge rule is too lenient in this case, implementing a rule that attempts to measure the "true" amount of deferral achieved by the COT could prove to be quite complex.[56] On balance, we think that if the interest-charge rule as currently drafted leaves a loophole, it is not a particularly meaningful one.[57] We believe that the effort to craft a more comprehensive response to issues of deferral should not be limited to COTs and should not be undertaken without further study.

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[56] At the end of the day, an effort to measure the true value of deferral points toward giving the taxpayer the same income and loss that would have applied had the taxpayer owned the Underlying directly. Among other things, this raises the question whether the taxpayer should be allowed to claim losses when it would have been permitted to do so as owner of the Underlying. As previously discussed, implementing such a regime presumably would mean applying conduit principles and, in the case of "leveraged" COTs, treating the taxpayer's counterparty, in effect, as a source of financing. *See* Part IV.D.1, above.

[57] Another deferral possibility that should be noted would involve the entry into a "short-term" total-return COT with respect to a hedge fund, where the termination of the COT produced only short-term capital gain but the gain was attributable largely to amounts realized in the prior tax year. For instance, the taxpayer could enter into a total-return hedge fund derivative on March 1, 1999 that matured on February 1, 2000. While this might seem like a potentially significant loophole, we are doubtful of this conclusion. The costs of the transaction (including the loss of opportunity to claim any long-term capital gain that might be allocable to a partner in the fund) would probably outweigh the deferral benefit.

Another interest-related issue is the rate charged pursuant to proposed Section 1260(b)(1). The underpayment rate under Section 6621(a)(2) is punitive in the sense that it exceeds the interest rate that a taxpayer entering into a COT would typically pay on a borrowing. We recognize that, as a general matter, the underpayment rate is not intended to be taxpayer-friendly, and we also understand why, as a conceptual matter, the underpayment rate is the "natural" rate to apply when taking away the benefit of deferral. Thus, the basic PFIC regime imposes interest at the underpayment rate with respect to the deferred tax amount[58] — and as a consequence, taxable U.S. investors have an extreme aversion to holding stock of a PFIC unless a QEF or mark-to-market election is available. As previously observed, Section 1260 is generally less harsh than the "all-ordinary" PFIC regime. Despite the fact that Section 1260 presents a more balanced approach than the PFIC rules, it seems fairly predictable that enactment of Section 1260 will lead taxable U.S. investors to develop an aversion to COTs to which the interest charge may apply. Perhaps this is the intended result with respect to COTs on hedge funds, PFICs, *etc.* In any event, we have some concern about applying the underpayment interest charge with respect to COTs on debt and SubC stock, in view of the possibility that the regime will reach transactions entered into without any view to achieving a deferral benefit. A possible alternative to the underpayment interest rate would be a rate determined somewhat along the lines set out in Section 1258(d)(2) (*e.g.*, 120% of the applicable federal rate that would have applied under Section 1274(d) to a bond issued at inception of the COT and having the same maturity as the COT).[59]

VI. Recommendation to Defer Implementation of the Mark-to-Market Election

We strongly suggest leaving to regulations (or to other legislation) the question of the availability and scope of an elective all-ordinary mark-to-market regime. We would be particularly concerned about making such an elective regime immediately available if the Bill is to apply to COTs with respect to SubC stock and debt instruments. Such a regime might skew economic decision-making as to the form of transactions commonly entered into by both individuals and corporations. For instance, an individual who planned to buy and sell a share

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[58] *See* Section 1291(c)(3); *see also, e.g.*, Section 453A(c)(2).

[59] The interest rate might be determined on a one-time basis at inception of the COT. Another possibility would be a floating interest-charge rate determined as a multiple of the short-term applicable federal rate. We note that whatever rate is applied under Section 1260, that rate should presumably also apply under Section 1291 in order to prevent a discontinuity between the interest charge applicable to ownership of PFIC stock and the interest charge applicable to a COT with respect to PFIC stock.

of stock during the same tax year would have an incentive to use a COT subject to the mark-to-market regime rather than to buy the stock itself, so that any loss realized would be ordinary rather than capital. The same individual would presumably buy the stock itself, rather than entering into a COT, if her intention was to hold the stock for a longer period. In addition, corporations, which enjoy no preferential capital gains rate, might be inclined to use COTs (particularly in the case of investments with a short-term horizon) in order to avoid the limitation on capital losses.

There are two possible responses to these concerns. First, the irrevocable nature of the election to be subject to a mark-to-market regime might dissuade most taxpayers from making the election — but in that case, why offer the election at all? Second, it can be argued that "avoiding" capital loss limitations is not abusive if the taxpayer agrees to all-ordinary mark-to-market treatment, since the principal justifications for the capital loss limitations are (1) to offset the elective nature of realization under our present system, and (2) as a "rough justice" trade-off to the benefit of a preferential capital gains rate. But in that case, why limit the all-ordinary mark-to-market regime to COTs?

A possible rejoinder would be that no harm is done by the Section 1260 mark-to-market regime, which (1) mitigates what may be viewed as the overly harsh result of the interest charge regime, and (2) provides a useful laboratory for what may eventually prove to be a broader extension of mark-to-market accounting (whether on an optional or mandatory basis). As regards mitigating the interest charge regime, that should be done directly (perhaps along the lines suggested above), assuming that Congress accepts the premise that a less harsh regime is appropriate. As to the argument for a modest step toward a broader mark-to-market regime, we remain skeptical. It is not clear to us that the Section 1260 mark-to-market regime would in fact prove either modest in scope or readily administrable. If, for instance, a taxpayer electing mark-to-market treatment enters into a COT and subsequently buys a put on the Underlying, is this a termination of the COT or, assuming it is entered into in the course of a trade or business, is it a hedging transaction potentially subject to Treas. Reg. §§ 1.1221-2 and 1.446-4, in which case the purchased put presumably also would be subject to mark-to-market, all-ordinary treatment? We believe that such questions deserve further discussion and should not be answered without the opportunity for public comment on proposed regulations.

VII. Other Technical Issues

A. *COTs Settled in Nonrecognition Transactions.*

As drafted, Section 1260 would not apply to a transaction in which a taxpayer agrees to pay an amount at some future date in exchange for delivery of the Underlying, because the settlement of such a transaction does not (under generally applicable principles) result in recognition of "gain" to which Section 1260(a) might apply. We believe that it is inappropriate to permit avoidance of the application of the Bill in this manner. To preclude this result, the Bill could provide that if a COT is settled in a transaction in which gain or loss is not fully recognized, then solely for purposes of applying the rules of proposed Sections 1260(a)(1) and (b), the COT will be treated as having been sold and then reacquired for its fair market value immediately prior to the settlement of the contract (with appropriate basis adjustments).[60]

Another possible approach (akin to the proposed treatment of the exercise of an option to purchase stock of a PFIC) would be to allow deferral of gain on the closing of a COT by purchase, but to "tack" the holding period of the COT to the holding period of the newly purchased property solely for purposes of determining the income recharacterization and applicable interest charge when gain is subsequently recognized with respect to the taxable disposition of the property acquired by purchase at maturity of the COT. *Cf.* Prop. Treas. Reg. Section 1.1291-1(h)(3). On balance, we would be inclined to favor the first approach, in part because we view it as providing better "closure" and in part because we view a regime that keeps the deferred interest clock ticking as punitive in view of the relatively high rate of interest that is charged.

B. *Compound Swaps.*

The Bill as drafted does not adequately address the treatment of "compound swaps" and other instruments the gain on which does not reflect the value (or changes in the value) of a single applicable financial instrument. For example, suppose a taxpayer enters into a swap in which he takes a "long" position in a hedge fund interest and a "short" position in corporation XYZ for five years. (In a simple swap, a taxpayer will ordinarily go "long" a particular asset and "short" LIBOR or some other interest rate index.)

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[60] We do not think it is appropriate to require the recognition of the portion of this "marked-to-market" amount that would continue to be treated as long-term capital gain after taking into account the application of Section 1260. Current law effectively permits the deferral of "built-in" long-term capital gains through the physical settlement of forward or option contracts, and the policy basis of Section 1260 does not require changing this result.

Suppose that the stock of corporation XYZ declines and the value of the hedge fund interest increases during the term of the swap. The taxpayer will have "won" *both* of his bets, which will result in long-term capital gain attributable to both bets. In our view, only the portion of the resulting long-term capital gain attributable to the increase in value of the hedge fund interest should be subject to the application of the Bill. For the reasons discussed above (*see* Part IV.B), we believe that the "short" leg of the swap should not be treated as a COT. One approach would be to "bifurcate" the transaction, treating the "long" position as a COT the gain on which is computed without "netting out" the gain or loss attributable to the "short" position.[61] We suggest that the legislative history indicate this as a possible approach but leave the ultimate resolution of the question to regulations.[62]

C. *Transactions in Which the Economics of the COT Do Not Mirror the Economics of a Constant Underlying.*

A different but related observation involves transactions in which the taxpayer enters into a COT the economics of which do not mirror the economics of a constant Underlying. We believe that the potential for misapplication of the Bill (favorably or unfavorably) to such transactions is quite significant, and that this is a subject that will require reasonably prompt regulatory guidance if the Bill is enacted.

As an example, suppose that a taxpayer agrees to pay $22 million at the end of 20 months in exchange for the value of the interest that would be held if $1 million had been invested in a hedge fund at the beginning of each of the 20

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[61] We have recommended against bifurcation in the context of withholding on derivative dividend payments made to foreign persons, *see* Withholding Report, *supra* note 15, and are concerned that such bifurcation may have unintended consequences. For this reason, we would urge caution in considering the appropriate treatment of compound swaps and other "complex" derivative instruments.

[62] The discussion in the text addresses the case of a "compound" COT in which the taxpayer receives credit for substantially all of the yield on the Underlying, netted against amounts determined by reference to a different notional property that is unrelated to the Underlying. Assume, by contrast, that a taxpayer enters into a contract with respect to stock of a foreign company that at the outset is worth $100 and 1000 units of foreign currency. The contract provides that after two years the taxpayer will pay $114 and receive an amount equal to the then-value of the foreign stock in the foreign currency, translated into dollars at the exchange rate that existed at inception of the contract. Because the taxpayer is not taking the foreign currency risks associated with the Underlying, it could be argued that the taxpayer has not acquired substantially all of the economics of the Underlying. Thus, it is not clear whether this transaction is, or should be, a COT at all.

months.[63] In such a case, the Underlying is not a constant "amount" of the hedge fund, but an interest growing over time pursuant to a formula. In such a circumstance, we believe that "net underlying long-term capital gain" should be determined with reference to the aggregate net capital gain that would have been recognized if the Underlying applicable financial instrument or instruments had been acquired at the time or times and at the price or prices determined under the COT and sold at the time or times and at the price or prices determined under the COT. (For this purpose, the $22 million "owed" by the taxpayer at maturity of the COT should be allocated to the different "tranches" in a manner reflecting the time value of the "notional" investments, subject to any other adjustments necessary to reflect the economic substance of the overall transaction).

As an additional example, a contract that provides for "serial" notional investments in different Underlying properties should be treated as a COT. For example, Section 1260 should apply to a forward contract that calls for delivery of an amount determined by reference to (i) an investment of $100 in a hedge fund interest for three years and (ii) a notional redemption of such interest and reinvestment of the proceeds in the S&P for years 4-5, with a dividend roll-up.[64]

D. *Definition of a COT*

As has been noted at various points in this report, we believe that the definition of a COT is somewhat flawed. The clear purpose of the Bill is to bring the tax consequences of "synthetic" ownership of certain instruments more closely into line with the consequences of actual ownership. Thus, paradigmatically, the Bill identifies a "total return swap" as a COT. However, in defining a "forward contract" as a COT, the Bill incorporates by reference the definition of a forward contract adopted in Section 1259(d)(1), namely, a contract to deliver a substantially fixed amount of property for a substantially fixed price. As previously discussed, a transaction may provide for specified changes in or additions to the notional investment, giving the taxpayer "total return" economics with respect to one or more Underlying assets for specified periods of time during the term of the contract. Such a contract would not necessarily provide for delivery of a substantially fixed amount of property, however. We therefore recommend that the definition of a "forward contract" be modified to include contracts that provide for one or more notional investments as well as contracts

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63 This is an "investment-averaging" derivative like that described in Part IV.D with respect to stock.

64 Again, we note that, as currently drafted, the definition of a "forward contract" would not encompass such a transaction.

that give the taxpayer the right to be paid or credited with any current return on the Underlying.[65]

Conversely, because we believe that the Bill is intended to, and should, address only instruments with "total return" economics (or substantially total return economics), we suggest that a transaction should be classified as a COT (whether or not it is an NPC) *only* if it gives the taxpayer a "long position" (as that term is defined with respect to a notional principal contract). We see no reason why (nor do we believe it is intended that) NPCs should be treated as COTs only if they provide the taxpayer with total return economics while forwards and put/call arrangements should be subjected to the rules of Section 1260 without regard to whether they provide the taxpayer with total return economics.

Finally, we believe that the Bill's description of a put/call arrangement that constitutes a COT should be modified to provide that a taxpayer has entered into a COT with respect to any financial position if the taxpayer is "long" with respect to such financial position as a result of holding a call option with respect to the same or substantially identical property, if the taxpayer (or a related person) is the grantor of a put option with respect to the same or substantially identical property and such options have substantially equal strike prices and substantially contemporaneous maturity dates.

E. *Legging Into or Out of a COT.*

Assume that a taxpayer buys a three-year option with respect to a hedge fund interest. The strike price of the option is $100, the value of the hedge fund interest at the time that the option is purchased. Assume that after two years, when the fair market value of the hedge fund interest is $120, the taxpayer sells a one-year put, having a strike price of $100, with respect to the hedge fund interest. The writing of the put option presumably would give rise to a COT with a term of one year. The taxpayer should be allowed to prove the value of the call option at the "leg-in" time (*i.e.*, the time that the put was purchased). This "built-in" gain should be exempted from Section 1260's recharacterization and interest charge rules.[66]

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[65] It should be irrelevant for this purpose whether the payment received by the taxpayer is in units of the Underlying, dollars or some other property.

[66] Because of the remaining one year of "optionality" in the call option at the time the put option is sold, the call option is presumably worth more than the $20 that could be realized on its exercise.

The "legging-out" problem arises when a taxpayer who holds a call and has written a put that collectively constitute a COT terminates one but not both of the positions. We believe that this situation should be addressed similarly to the situation where the COT terminates in a non-taxable purchase transaction.[67] In the interest of avoiding complexity, we generally would not permit a taxpayer who enters into a COT such as a forward contract or NPC to claim that entering into a position that reduced the taxpayer's exposure to the "total return" on the Underlying, such as the subsequent sale of a separate call, purchase of a separate put or entry into a "short" collar, constitutes a termination of the COT.

F. *Basis Step-Up*

The Bill does not address the tax treatment of the holder of a COT at death. We note that the Section 1014 basis step-up at death is denied in the case of holders of PFIC stock, and its availability is substantially limited in the case of "grandfathered" constructive sales transactions under Section 1259. As an argument against the denial of the basis step-up for COTs, we note that the duration of a COT is necessarily limited, and thus that the potential for revenue losses may not be great. We believe, moreover, that it is not appropriate to deny a basis step-up with regard to amounts that would have been treated as long-term capital gain after application of the Bill. Thus, if a basis step-up provision is enacted, it might operate in a manner similar to the provision proposed in Part VII.A for nonrecognition transactions.

G. *Mark to Market.*

As drafted, the Bill provides that a COT must be marked to market at the end of each year "as if the *financial position to which such transaction relates* were sold for its fair market value on the last business day of such taxable year." If the elective mark-to-market regime of proposed Section 1260(f) is retained, we believe that this language should be revised. A COT need not provide for economics identical to those of the Underlying. For example, suppose that a 98-103 "long collar" with respect to a partnership interest that is worth $100 at the time of entry into the collar is deemed to be a COT. If the partnership interest is worth $110 at the end of year 1, it is inappropriate to treat the taxpayer as having $10 of income. The mark-to-market rule should apply to the taxpayer's COT position, not to the Underlying.

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[67] *See* Section VII.A, above. An alternative approach would be to ignore this "legging-out" transaction but to provide that to the extent that any gain recognized with respect to an option is attributable to a period in which the option was part of a COT, such gain will be subject to Section 1260. We favor the former approach, in light of the punitive interest charge and the additional complexity inherent in "tracing" gain from options transactions in this manner.

Appendix A

105TH CONGRESS
2D SESSION

H.R. 3170

IN THE HOUSE OF REPRESENTATIVES

Mrs. KENNELLY of Connecticut introduced the following bill; which was referred to the Committee on ______________________

A BILL

To amend the Internal Revenue Code of 1986 to prevent the conversion of ordinary income or short-term capital gain into income eligible for the long-term capital gain rates, and for other purposes.

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

SECTION 1. CAPITAL GAIN TREATMENT OF GAIN FROM CONSTRUCTIVE OWNERSHIP TRANSACTIONS.

(a) IN GENERAL.—Part IV of subchapter P of chapter 1 of the Internal Revenue Code of 1986 (relating to special rules for determining capital gains and losses) is amended by inserting after section 1259 the following new section:

"SEC. 1260. GAINS FROM CONSTRUCTIVE OWNERSHIP TRANSACTIONS.

"(a) IN GENERAL.—If the taxpayer has gain from a constructive ownership transaction with respect to any financial position and such gain would (without regard to this section) be treated as a long-term capital gain—

"(1) such gain shall be treated as short-term capital gain to the extent that such gain exceeds the net underlying long-term capital gain, and

"(2) to the extent such gain is treated as a long-term capital gain after the application of paragraph (1), the determination of the capital gain rate (or rates) applicable to such gain under section 1(h) shall be determined on the basis of the respective rate (or rates) that would have been applicable to the net underlying long-term capital gain.

"(b) INTEREST CHARGE ON DEFERRAL OF GAIN RECOGNITION.—

"(1) IN GENERAL.—If any gain is treated as short-term capital gain for any taxable year by reason of subsection (a)(1), the taxpayer's tax imposed by this chapter for such taxable year shall be increased by the amount of interest which would have been imposed under section 6601—

"(A) for periods ending on the due date (without extensions) for the return of tax imposed by this chapter for such taxable year, and

"(B) on underpayments of tax for prior taxable years which would have resulted had such gain been included in gross income ratably during the period the constructive ownership transaction was open.

Any amount payable under this paragraph shall be taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid or accrued during such taxable year.

"(2) NO CREDITS AGAINST INCREASE IN TAX.—Any increase in tax under paragraph (1) shall not be treated as tax imposed by this chapter for purposes of determining—

"(A) the amount of any credit allowable under subpart A, B, D, or G of part IV of subchapter A of chapter 1, or

"(B) the amount of the tax imposed by section 55.

"(c) FINANCIAL POSITION.—For purposes of this section—

"(1) IN GENERAL.—The term 'financial position' means any position with respect to any stock, debt instrument, partnership interest, or investment trust interest.

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

"(d) CONSTRUCTIVE OWNERSHIP TRANSACTION.—

"(1) IN GENERAL.—The taxpayer shall be treated as having entered into a constructive ownership transaction with respect to any financial position if the taxpayer (or a related person)—

"(A) holds a long position under a notional principal contract with respect to the same or substantially identical property,

"(B) enters into a forward or futures contract to acquire the same or substantially identical property,

"(C) is the grantor of a put, and is the holder of a call, with respect to the same or substantially identical property and such options have substantially equal strike prices, or

"(D) 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 POSITIONS WHICH ARE MARKED TO MARKET.—This section shall not apply to any constructive ownership transaction if all of the positions which are part of such transaction are marked to market under any provision of this title or the regulations thereunder.

"(3) LONG POSITION.—A person shall be treated as holding a long position under a notional principal contract with respect to any property if such person—

"(A) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on such property for a specified period, and

"(B) is obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of such property.

"(4) FORWARD CONTRACT.—The term 'forward contract' has the meaning given to such term by section 1259(d)(1).

"(5) RELATED PERSON.—The term 'related person' has the meaning given to such term by section 1259(c)(4).

"(e) NET UNDERLYING LONG-TERM CAPITAL GAIN.—For purposes of this section, in the case of any constructive ownership transaction with respect to any financial position, the term 'net underlying long-term capital gain' means the aggregate net capital gain that the taxpayer would have had if—

"(1) such position had been acquired on the date such transaction was opened and sold on the date such transaction was closed, and

"(2) only gains and losses that would have resulted from the deemed ownership under paragraph (1) were taken into account.

The amount of the net underlying long-term capital gain with respect to any financial position shall be treated as zero unless the amount thereof is established by clear and convincing evidence.

"(f) EXCEPTION IF MARK TO MARKET ELECTED.—

"(1) IN GENERAL.—In the case of a taxpayer who elects to have this subsection apply—

"(A) subsections (a) and (b) shall not apply,

"(B) such taxpayer shall recognize gain or loss on any constructive ownership transaction which is open as of the close of any taxable year as if the financial position to which such transaction relates were sold for its fair market value on the last business day of such taxable year, and

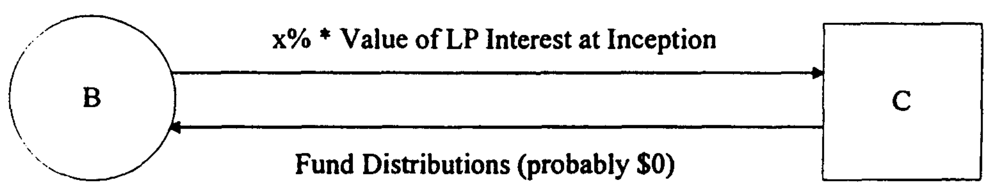
"(C) any gain or loss shall be taken into account for such taxable year.

Proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account under the preceding sentence.

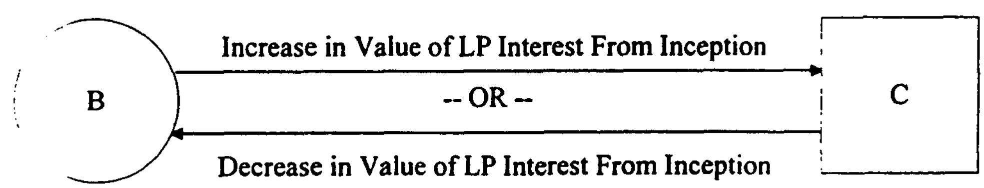
Hedge Fund Swap

On January 1, 19xx, an individual U.S. investor ("A") invests \$1m to acquire a limited partner interest (the "LP Interest") in a domestic "hedge fund" partnership that trades in (and takes derivative positions with respect to) stocks, securities and other financial assets (the "Fund"). At the same time, a second U.S. individual investor ("B") and a counterparty ("C") enter into a four-year notional principal contract (the "Swap") with respect to an identical \$1m LP Interest in the Fund. The Swap provides that quarterly, for a period of four years, B will pay C an amount equal to an interest rate multiplied by the initial value of the LP Interest (\$1m), and C will pay B the value of any distributions that would have been received from the Fund by a holder of the LP Interest. Based on historical experience, it is not expected that the Fund would distribute earnings to a partner except in connection with complete or partial redemption of the partner's interest in the Fund. At the end of four years, C will pay B the amount of any increase in the value of the LP Interest since the inception of the NPC, or, if the LP Interest has decreased in value, B will pay C the amount of such decrease. The cash-flows under the Swap are summarized below:

Quarterly Payments (Netted):



Final Payment:



There are obvious parallels between the economic positions of A and B. To strengthen the parallelism, assume that A borrows the $1m used to purchase the LP Interest and makes quarterly interest payments to his lender equal in amount to the "interest factor" payment that B makes to C pursuant to the NPC. Also, assume that at the end of four years A liquidates his LP Interest and uses the proceeds (plus additional cash, if necessary) to pay off the $1m loan. At the end of the day, A and B will have had the same cash flows (apart from taxes). To illustrate, assume that after four years the value of the LP Interest has increased from $1m to $2.5m (attributable to $1.5m of net short-term trading gains, all of which have been recognized). In this case, A liquidates his LP interest for $2.5m, pays $1m to the lender, and ends up with $1.5m in hand. Similarly, B receives a $1.5m payment from C (the increase in the value of the LP Interest during the term of the Swap).

Notwithstanding the strong economic similarities between their positions, A and B will likely have quite different tax consequences under current law. Each year A will take into account his distributive share of the Fund's items of gain, loss, income and deduction.[1] Thus, in the example given above, A is taxed with respect to the Fund's $1.5m of short-term trading gains as such amounts are recognized. B, on the other hand, will not be taxed on the $1.5m build-up in value of the LP Interest until the maturity of the Swap (assuming that B is not treated as owner of the LP Interest — an issue discussed below).

There is some question whether the payment B receives at maturity of the swap is capital in character.[2] The issue of the character of the final swap payment is somewhat academic, however, because it is quite clear that B can achieve long-term capital gain treatment by terminating the Swap prior to its scheduled maturity.[3]

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[1] A will also be allowed a deduction for his payments of interest, subject to generally applicable rules (including the limitation on deductibility of investment interest).

[2] *See* Tech. Adv. Mem. 9730007 (Apr. 10, 1997) (periodic payments made or received pursuant to the terms of a swap treated as ordinary in character). *Cf.* Tax Section, New York State Bar Ass'n, *Report on Notional Principal Contract Character and Timing Issues,* 79 TAX NOTES 1303 (June 8, 1998) (the "Report") (very strong policy arguments exist for treating the final non-periodic payment on a "contingent payment" equity swap as capital in character pursuant to Section 1234A). As discussed in the Report, there is also some uncertainty under current law regarding the deductibility of the periodic "interest factor" payments made by B.

[3] Under Section 1234A, "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset." Under Treas. Reg. § 1.1092(d)-1(c)(2), "the rights and (continued...)

B can also achieve comparable tax and economic results by entering into other derivative transactions. For instance, B can enter into a cash-settleable forward contract to purchase the LP Interest from C in four years.[4] Similarly, B can simultaneously buy from C a "call" option and sell to C a "put" option with respect to the LP Interest, with each option having a maturity date and a "strike" price equal to the "forward" price.[5] B can achieve further deferral by paying cash and taking delivery of the LP Interest pursuant to such a forward or option contract, in which case B would not recognize gain and would take a holding period in the LP Interest beginning on the day following the purchase.

It could be argued that any of the foregoing "total return" derivative transactions gives B the economic benefits and burdens of ownership of the LP Interest and therefore, under the common law of federal income taxation, she should to be treated as owner of an LP Interest (that is, as a partner who, like A, must account for the portion of the Fund's items of income, gain, loss, deduction and credit allocable to an LP Interest). This argument would have little force unless C held an actual LP Interest to hedge its exposure under the derivative transaction with B. Even assuming this to be the case, however (as it typically would be), there is relatively strong support for the proposition that, under current law, B will not be treated as the tax owner of an LP interest *unless* she has acquired full "dominion and control" over the LP Interest held by C — which requires more than merely taking on exposure to the fluctuations in value of the LP Interest.

Rev. Rul. 77-137, 1977-1 C.B. 178, holds that where the assignee of a partnership interest cannot, as a consequence of the partnership agreement, become a substitute limited partner, an agreement by the assignor to exercise all of its residual rights in favor of the assignee will cause the assignee to acquire

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[3] (...continued)
obligations of a party to a notional principal contract are rights and obligations with respect to personal property and constitute an interest in personal property." Thus, termination of the Swap terminates B's rights and obligations with respect to property that is, or on acquisition would be, a capital asset. (This conclusion holds whether the "property" in question is viewed as the LP Interest or the Swap itself.) It should be noted that prior to the Tax Reform Act of 1997, Section 1234A applied only to terminations of rights or obligations with respect to personal property of a type which is actively traded, and would therefore not have applied to a derivative with respect to the typical hedge fund.

[4] The purchase price under the forward contract will equal the initial value of the LP Interest ($1m) increased by an interest factor that should equal the amount (adjusted for time value of money) of the periodic payments B would have made to C under the Swap.

[5] The option premium paid by B to acquire the call option should equal the option premium it receives for granting the put option, so that the no net cash changes hands.

"dominion and control" over the partnership interest and to become a substitute limited partner for tax purposes. Gen. Couns. Mem. 36960 (Dec. 20, 1976) (the "GCM"), which analyzes the issues underlying Rev. Rul. 77-137, emphasizes the importance of an agreement by the assignor to exercise its residual rights in favor of the assignee. After surveying the provisions under the Uniform Partnership Act and the Uniform Limited Partnership Act regarding the existence of such residual rights of the assignor and the limitations on the rights of the assignee (*e.g.*, inability to vote, inspect partnership books, and obtain an accounting, and in some cases inability to withdraw capital prior to dissolution of the partnership), the GCM concludes that "in the absence of some specific provision for the exercise of these residual rights in favor of and solely in the interest of the assignee, the assignor should continue to be taxed on the partnership distributive shares as still having dominion and control over the assigned interest."

In reaching this conclusion, the GCM relies on Treas. Reg. § 1.704-1(e) and *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971), *aff'g* 54 T.C. 40 (1970), *acq.*, 1978-2 C.B. 2. The regulations provide rules for determining whether an alleged partner is the tax owner of a capital interest in a partnership in which capital is a material income-producing factor.[6] They require that the purchaser or donee acquire "dominion and control" of the partnership interest in order to be recognized as tax owner, and list factors that are significant in determining tax ownership. For example, the regulations state that "if the limited partner's right to transfer or liquidate his partnership interest is subject to substantial restrictions . . ., such restrictions . . . will be considered strong evidence as to the lack of reality of ownership by the donee."[7] *Evans* involves facts and a holding quite similar to those of Rev. Rul. 77-137.

The analysis set out in Treas. Reg. § 1.704-1(e), *Evans*, and GCM 36960 is a subset of a long line of authorities that analyze the "benefits and burdens of ownership" in determining who is the tax owner of property.[8] The "benefits and

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[6] While Treas. Reg. § 1.704-1(e) is entitled "Family Partnerships," the court in *Evans* held that its principles apply to non-family partnerships as well, and to cases involving purchases as well as gifts. 447 F.2d at 550.

[7] Treas. Reg. § 1.704-1(e)(2)(ix).

[8] *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (courts look to economic realities in determining ownership of property for tax purposes; sale-leaseback transaction respected as transferring ownership to lessor); *Hilton v. Comm'r*, 74 T.C. 305 (1980), *aff'd per curiam*, 671 F.2d 316 (9th Cir. 1982) (sale-leaseback left seller-lessee with benefits and burdens of ownership; form of transaction not respected); Rev. Rul. 82-150, 1982-2 C.B. 110 (taxpayer who acquired for $70,000 an option, exercisable at any time, to buy for $30,000 the stock of a foreign personal holding company capitalized with $100,000 has assumed the benefits
(continued...)

burdens of ownership" test has generally been applied in cases involving non-fungible property where the "true" tax owner either retained a possessory right (as in failed sale-leaseback transactions) or had a right to acquire the specific property. There is considerably less precedent applying "benefits and burdens" analysis in the context of derivatives transactions. Thus, in enacting Section 1259, Congress observed that under prior law arrangements such as equity swaps generally could be used to transfer risk of loss and opportunity for gain on appreciated property without triggering a sale of the property for tax purposes.[9] In addition, Section 1259 provides for gain recognition but otherwise treats the "constructive seller" as retaining tax ownership. *See* Section 1259(a)(2)(B) (taxpayer's holding period in the property that is constructively sold treated as beginning on the date of the constructive sale).

More generally, a number of authorities have limited the imputation of tax ownership to persons who hold "long" economic positions but do not have control over the financial instrument in question. For example, Revenue Ruling 80-135, 1980-1 C.B. 18, holds that a lender of tax-exempt municipal securities is not the tax owner of the lent securities and so is not entitled to treat the "in lieu of interest" payments received from the securities borrower as tax-exempt income. Similarly, Revenue Ruling 60-177, 1960-1 C.B. 9, holds that a lender of stock may not claim the dividends-received deduction with respect to "in lieu of dividend" payments.[10] These authorities reflect a concern for the possibility that tax ownership of tax-advantaged positions will be duplicated.

B's contention that she should not be treated as the owner of an LP interest is also supported by several potentially meaningful economic differences between her rights and obligations as a party to the Swap and the rights of a direct owner of an LP Interest. Perhaps most significantly, B bears the risk of default by C.[11]

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[8] (...continued)
and burdens of ownership, and the sale must be treated as completed).

[9] *See* S. Rep. No. 105-33, 105th Cong., 1st Sess. 122-23 (1997); H.R. Rep. No. 105-148, 105th Cong., 1st Sess. 181 (1997).

[10] More recently, the Treasury has stated in the preamble to the final Section 905 foreign tax credit substantiation regulations that, for purposes of substantiating entitlement to foreign tax credits, it is considering the issue of tax ownership of underlying foreign securities by American Depositary Receipt holders where financial intermediaries are taking actions with respect to the underlying securities that are inconsistent with such tax ownership. *See* T.D. 8759, 63 Fed. Reg. 3812 (Jan. 27, 1998).

[11] *Cf. Goldsmith v. United States*, 586 F.2d 810, 817-19 (Ct. Cl. 1978) (employee does not own a life insurance contract acquired by employer to fund terminable deferred compensation
(continued...)

In addition, an owner has the right to redeem the LP Interest whenever the Fund permits, whereas B has no such right during the term of the Swap. Moreover, B's economic returns reflect a leverage factor that is "locked in" during the term of the Swap, whereas an owner may or may not borrow to acquire the LP Interest, and may pay off any such loan without regard to whether it continues to hold the LP Interest.

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[11] (...continued)
arrangement, where employee's only rights against employer were as a general creditor); Rev. Proc. 92-64, 1992-2 C.B. 422 (rules pertaining to "rabbi trust" arrangements).

Appendix C

S&P-Based Investment	Governing Tax Rules
All 500 individual stocks	General tax principles (capital/ ordinary, dividends-received deduction, etc.)
Stock in S&P 500 Index Fund or an AMEX SPDR	Section 851 *et. seq.*
S&P 500 futures contract	Section 1256
Total returns swap on S&P 500 stocks	Treas. Reg. Section 1.446-3, Section 1234A (only on termination or sale?)
Forward contract to acquire the S&P 500 stocks	Section 1234A on cash-settlement or sale; no gain or loss on physical delivery
Prepaid forward contract to purchase the S&P 500 stocks	Section 1234A on cash-settlement or sale; general principles (presumably meaning no gain or loss on physical delivery and no interest accrual under current law)
Purchase exchange-listed S&P 500 call option and sell exchange-listed S&P 500 put option	Section 1256
Purchase S&P 500 OTC call option and sell S&P 500 OTC put option	Section 1234; Rev. Rul. 78-182
Purchase principal-protected bond with contingent maturity payment linked to the S&P 500 and sell S&P 500 put option	Bond — Treas. Reg. Section 1.1275-4; Put option — either Section 1256 (exchange-listed) or Section 1234 and Rev. Rul. 78-182 (OTC)
Bond mandatorily exchangeable for the S&P 500 stocks	Deposit plus a forward contract (?) — interest during term; Section 1234A on cash-settlement or sale; no gain or loss on physical delivery. Alternative — Treas. Reg. 1.1275-4
Purchase a variable annuity contract indexed to the S&P 500 index	Section 72