Tax Report #959

New York State Bar Association

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July 8, 1999

Hon. Jonathan Talisman
Deputy Assistant Secretary, Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 1330
Washington, D.C. 20220

Dear Secretary Talisman:

Enclosed is a report of the New York State Bar Association, Tax Section, commenting on H.R. 1703, the "Constructive Ownership" Bill introduced by Representative Neal on May 5, 1999, as well as on the "Constructive Ownership" proposal offered in the Administration Budget for Fiscal Year 2000. Each is a variation of the "Constructive Ownership" Bill proposed by Rep. Kennelly on February 5, 1998, on which we commented in our report issued July 14, 1998. These measures target certain derivative transactions that simulate direct ownership of a financial asset in an attempt to achieve more favorable tax treatment in two respects: (1) deferral of gain and (2) conversion of ordinary income or short-term capital gain into long-term capital gain. The most common transaction involves investment partnerships, known as hedge funds, that typically engage in frequent short-term trading. Instead of investing directly in the fund, and thus including their distributive share of short-term capital gains and ordinary income each year, taxpayers have entered into derivatives based on the hedge fund's value. Under current law, if the derivative remains in effect for more than one year, its return is taxed as long-term capital gain (or loss) and is not taxed until the derivative is settled. In response, the Neal Bill would recharacterize a portion of the long-term capital gain on the derivative as short-term capital gain and impose an interest charge to counteract the tax deferral.

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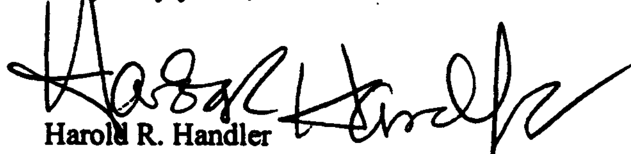
We endorsed the Kennelly Bill in our prior report, and we consider the Neal Bill a significant improvement in a number of respects and support its adoption. As revised, it addresses many of the technical issues we raised concerning the Kennelly Bill. In this report, we recommend ways to address additional technical issues. The following are our five principal recommendations: First, we agree with Representative Neal that the constructive ownership regime should not be confined to derivatives on partnership interests. It should also cover certain derivatives on other pass-thru entities. Second, we would treat recharacterized gain as ordinary income rather than as short-term capital gain. Third, we would narrow the definition of "forward contract" to exclude forwards that do not convey substantially all of the underlying's economic return. Fourth, we offer ways to conform the constructive ownership and PFIC regimes. Finally, we suggest ways to prevent taxpayers from avoiding the constructive regime by interposing a pass-thru entity that would hold the derivative.

We would be pleased to discuss this with you at your convenience.

Very truly yours,



Harold R. Handler
Chair

cc: Joseph M. Mikrut, Esq.

Enclosure

Tax Report # 959

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMENTS ON CONSTRUCTIVE OWNERSHIP AND H.R. 1703

INTRODUCTION[1]

This report comments on H.R. 1703, the "Constructive Ownership" bill introduced by Representative Neal on May 5, 1999 ("the Bill"),[2] as well as on the "Constructive Ownership" proposal offered in the administration's budget in February 1999 ("the Administration Proposal"). Each is a variation of the "Constructive Ownership" bill proposed by Rep. Kennelly on February 5, 1998 ("the Prior Bill"), on which we commented in our report issued July 14, 1998 ("the Prior Report").[3]

These measures target certain derivative transactions that simulate direct ownership of a financial asset but may offer more favorable tax treatment in two respects: deferral of gain and conversion of ordinary income or short-term capital gain into long-term capital gain. The most common transaction involves investment partnerships, known as hedge funds, that typically engage in frequent short-term trading. Instead of investing directly in the fund, and thus including their distributive share of short-term capital gains and ordinary income each year, taxpayers have entered into derivatives based on the hedge fund's value. Under current law, if the derivative remains in effect for more than one year, its return is taxed as long-term capital gain (or loss) and is not taxed until the derivative is settled.[4] Although the counterparty on the derivative usually holds the hedge fund interest, and thus has current inclusions, the counterparty is typically a securities dealer subject to mark-to-market accounting. As such, it is relatively indifferent to timing and character effects because any gains on the hedge fund interests are offset by (ordinary) losses on the derivative, and generally vice versa. As long as the counterparty is a securities dealer or another tax-indifferent party, no one bears the tax burden associated with the portion of the hedge fund's short-term capital gains or ordinary income allocable to the interest held by the counterparty.

In response, the Bill would recharacterize a portion of the long-term capital gain on the derivative as short-term capital gain and impose an interest charge to counteract the tax deferral. The Bill and Administration Proposal are each narrower than the Prior Bill, which applied to all positions in stock, debt, partnerships and investment trusts. While the

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[1] The principal author of this report is David M. Schizer. Helpful comments were received from Peter Blessing, Samuel Dimon, Michael Farber, Victor Fleischer, Philip Gross, Harold Handler, Robert Jacobs, David Miller, John Narducci, Robert Scarborough, and Michael Schler.

[2] A copy of the Bill is attached as an appendix.

[3] See New York State Bar Association Comments on H.R. 3170, *reprinted in* 98 TNT 136-38 (July 16, 1998).

[4] The above analysis assumes the transaction's form is respected -- an issue that this report does not address. For a discussion of current law, see Appendix B of our Prior Report.

Administration Proposal applies only to derivatives on partnership interests, the Bill would cover derivatives on equity interests in other pass-thrus (*e.g.*, RICs, REITs, PFICs, etc.) and, to the extent provided in regulations, derivatives on other common stock and debt. This report focuses on the Bill but also explores its key differences from the Administration Proposal.

The Bill defines three core cases that constitute a constructive ownership transaction ("COT") with respect to an underlying "financial asset" — a long position under a notional principal contract, a forward contract, and a "put / call" combination where the strike prices are substantially equal and the maturity dates are substantially contemporaneous. The Bill also uses a catchall category for one or more other transactions that have "substantially the same effect" as the three core cases.

The Bill recharacterizes long-term capital gain from the COT as short-term capital gain[5] to the extent that 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. An addition to tax, in the nature of an interest charge on tax deferral, applies to amounts recharacterized as short-term capital gain ("Recharacterized Gain"). The interest is computed by applying § 6601[6] to the hypothetical underpayment that would have resulted if the Recharacterized Gain had been recognized during the term of the COT at a constant rate (based on the applicable federal rate in effect when the COT is settled).

I. SUMMARY

We endorsed the Prior Bill in our Prior Report, and we consider the Bill a significant improvement in a number of respects. As revised, it addresses many of the technical issues we raised concerning the Prior Bill. In this report, we recommend ways to address additional technical issues. The following are our five principal recommendations:

First, we agree with Representative Neal that the constructive ownership regime should not be confined to derivatives on partnership interests. It should also cover certain derivatives on other pass-thru entities.

Second, we would treat Recharacterized Gain as ordinary income rather than as short-term capital gain.

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5 The Administration Proposal would recharacterize the amounts as ordinary income.

6 References to Sections are to the Internal Revenue Code of 1986, as amended. References to "Proposed § 1260" are to the Bill.

Third, we would narrow the definition of "forward contract" to exclude forwards that do not convey substantially all of the underlying's economic return.

Fourth, we offer ways to conform the constructive ownership and PFIC regimes.

Finally, we suggest ways to prevent taxpayers from avoiding the COT regime by interposing a pass-thru entity that would hold the derivative.

II. THE BILL vs. THE PRIOR BILL

We endorsed the Prior Bill in our Prior Report, and we consider the Bill to be a significant improvement in a number of respects. As revised, it addresses many of the technical issues we raised concerning the Prior Bill. We commend Representative Neal and his staff for their determination to improve the Bill and for their receptivity to comments, and we greatly appreciate the recognition Representative Neal gave to our organization's comments in remarks accompanying introduction of the Bill.

A. Scope

The Bill narrows the Prior Bill's scope in three important respects. It would apply only through regulations to common stock of a corporation that is not a pass-thru entity and to debt,[7] and it would not apply to short sales. Consistent with our Prior Report, we support each adjustment.[8]

B. Consequences

The Bill also addresses two of our concerns about consequences of constructive ownership under the Prior Bill. First, the Bill defers to regulations the possibility that taxpayers might elect mark-to-market treatment for their constructive ownership transactions — an option that, in our view, raises concerns and requires further analysis.[9] Second, the Bill clarifies that a taxpayer cannot avoid recharacterization and the interest charge by physically settling the derivative; the Bill's solution is also suitably tailored, as it leaves intact nonrecognition for gain that would not be recharacterized.[10]

III. BILL vs. ADMINISTRATION PROPOSAL

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7 See Proposed § 1260(c)(1)(B).

8 Prior Report, at 12-18, 21-25.

9 Proposed § 1260(g). The Administration Proposal would not defer the mark-to-market election to regulations.

10 Proposed § 1260(f).

The Bill and the Administration Proposal differ in two principal respects, which are considered in turn.

A. Partnerships Only

The Administration Proposal would apply only to derivatives on partnership interests, whereas the Bill would also apply to derivatives on other pass-thru entities and, under regulations, to certain derivatives on debt and common stock. As we stated in our Prior Report, we believe the problem at issue here — using derivatives to avoid adverse tax consequences of direct ownership, while assigning tax ownership to a tax-indifferent counterparty — is not unique to partnerships. We noted that it is also presented by passive foreign investment companies ("PFICs"), regulated investment companies ("RICs"), and real estate investment trusts ("REITs"), and we agree with Representative Neal that it also applies to the other pass-thrus listed in the Bill.[11] Although we have expressed reservations about applying constructive ownership to debt and to "plain vanilla" common stock, our concerns are accommodated by applying this regime under regulations, as the Bill would do; the Treasury would then have the time to seek comments and resolve the many potentially difficult issues that would arise.

B. Ordinary Income vs. Short-term Capital Gain

Under the Bill, long-term capital gain would be recharacterized as short-term capital gain. Under the Administration proposal, it would be recharacterized as ordinary

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[11]We notice the Bill's definition of "financial asset" includes PFICs, foreign personal holding companies ("FPHCs"), and foreign investment companies ("FICs"), but not controlled foreign corporations ("CFCs"). We support this omission. Shareholders have inclusions from a CFC only if they are "United States shareholders" (*i.e.*, in general, they are deemed to own shares representing more than 10% of the CFC's voting rights or value). If the COT regime were applied to CFCs, recharacterization and the interest charge presumably would apply only to taxpayers that have an interest, through the derivative and any direct holdings, that in some sense represents 10% of vote or value. Rather than add this potentially complex inquiry to the COT regime, we would omit CFCs from the definition of financial assets, as the Bill has done. The Bill still covers COTs on CFCs that invest or trade in securities or otherwise engage in passive activities, because these CFCs ordinarily would also qualify as PFICs, FPHCs, or FICs. Use of derivatives based on other CFCs (*e.g.*, those with active businesses, which do not qualify as PFICs) could be addressed, as necessary, through the CFC regime; for example, "total return" derivatives could be treated as stock for certain purposes.

To prevent taxpayers who are "United States shareholders" in a CFC that is a PFIC from avoiding the COT regime, though, we would modify the Bill's definition of "financial asset" in Proposed § 1260(c)(2)(G). To the phrase "a passive foreign investment company (as defined in 1297)" we would add "but without regard to Section 1297(e)."

income.[12] We prefer the latter approach. In our experience, a significant portion of the return from pass-thru entities constitutes ordinary income. For example, REITs often pass through significant ordinary income (*e.g.*, from rents), as do hedge funds that engage in certain types of interest-rate arbitrage. Also, if the underlying is a PFIC for which a QEF election is not in effect, all of the gain is ordinary. Under the Bill's approach, taxpayers might continue to use COTs to transform ordinary income to short-term capital gain, which could then be absorbed by otherwise unusable long-term or short-term capital losses. To foreclose this potential gaming, we recommend the Administration's approach.

IV. TECHNICAL COMMENTS ON THE BILL

A. *Definition of Forward Contracts*

Our Prior Report recommended an expansion of the Prior Bill's definition of forward contract. The definition was taken from § 1259(d)(1)'s definition, "a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price." Our concern was that this definition failed to pick up "total return" long positions that did not provide for a fixed amount of property, such as dividend-rollup, investment-averaging, and serial-investment transactions. Assume, for example, that a taxpayer agrees to pay a fixed amount of money in two years and, in return, will receive X shares of stock plus the number of additional shares that could have been purchased by immediate reinvestment of the dividends paid with respect to the stock during the forward's two year term. In so doing, the taxpayer would transform what otherwise would be ordinary dividend income into long-term capital gain, but, under the Prior Bill's definition, the amount of property could be too variable to qualify. Likewise, assume that the taxpayer agrees on January 1, 2000 to pay $124 on January 30, 2001 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 2000 in XYZ stock. The taxpayer's return from investments made after January 30, 2000 are transformed to long-term capital gain but, again, the amount of property is not substantially fixed. Finally, assume the taxpayer enters into a 13 month total return swap that is based, for the first six months, on the value of one hedge fund and, for the next seven months, on the value of a notional reinvestment in a second hedge fund. Again, if the investment is profitable, the investor would transform short-term gain into long-term gain, but the amount of property is not substantially fixed.

The Bill's definition has been expanded to cover these transactions but, in our view, it is now too broad. It would define a forward as "any contract to acquire in the future (or provide and receive credit for future value of) any financial asset." This language would apply to

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[12]The most nuanced approach would distinguish between the two by recharacterizing long-term capital gain as either ordinary income or short-term capital gain -- exactly to the extent the underlying would have generated one or the other. Yet this approach is more complex, in that it would require additional statutory categories such as "net underlying short-term capital gain" and / or "net underlying ordinary income." To avoid this complexity, we consider it preferable to choose one or the other.

contracts that do not trigger the abuse here — simulating a current investment, while achieving better tax treatment. For example, the Bill's definition would apply to contracts that do not give the "long" counterparty the underlying's economic return, such as a contract to purchase an asset for its fair market value on the settlement date. Likewise, the Bill would apply to a forward to acquire a partnership interest for the lesser of a fixed price (*e.g.*, $100) or its fair market value at maturity. In providing the buyer with opportunity for gain (*i.e.*, as the partnership interest appreciates above $100) but no risk of loss, this forward is economically equivalent to a call option, and thus should fall outside the Bill's scope. Yet the Bill's current definition would include it.

To avoid overbreadth, we recommend the following formulation:

> The term "forward contract" means a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price. For this purpose, except to the extent provided in regulations, a contract that provides (i) that the taxpayer has the right to be paid (or receive credit for) any current payments made with respect to property during the term of such contract or (ii) for one or more notional investments, dispositions and / or reinvestments (whether or not in the same property) will not in either case for that reason fail to be treated as a forward contract. Appropriate adjustments will be made to the determination of "net underlying long term capital gain" to account for all such notional payments, investments, dispositions and / or reinvestments.

B. Derivatives on Derivatives

Our Prior Report expressed concern that in some cases it would be unclear what actually was constructively owned – that is, what the "true" underlying would be.[13] The Prior Bill was ambiguous because it offered a relatively broad category of property that could be constructively owned, called "financial positions." This category included not only basic underlyings (*i.e.*, stock, debt, partnerships or investment trusts), but also any "position" (*i.e.*, derivative) with respect to them.[14] The Bill replaces "financial positions" with the narrower concept of "financial assets," defined as "any equity interest in any pass-thru entity and, to the extent provided in regulations any debt instrument and any stock in a corporation which is not a pass-thru entity."[15] We understand this change to indicate that derivatives generally will not be the subject of COTs, except perhaps as provided in regulations.[16] However, a derivative on a

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[13] Prior Report, at 10-12.

[14] Specifically, "position" was defined as an "interest" in them, "including a futures or forward contract, short sale or option."

[15] Proposed § 1260(c)(1)(A).

[16] To the extent Congress intends to give Treasury regulatory authority to address (continued...)

derivative presumably could be treated as a COT of the underlying, by application of the "substantially the same effect" test.[17]

C. *Imitating a "Financial Asset"*

Taxpayers should not be able to evade the constructive ownership regime with derivatives based, not on a "financial asset" (*i.e.*, an interest in a pass-thru entity), but on a proxy for this value that, technically, does not qualify as a "financial asset." For example, what if the derivative is based on the value of the constantly changing portfolio of common stocks *held by* a particular pass-thru entity (rather than, strictly speaking, on the value of the pass-thru interest itself)? Alternatively, a foreign bank might hold a derivative based on a pass-thru entity, and issue tracking stock that tracks this derivative's value. What if a U.S. taxpayer held this tracking stock (or a derivative based on the tracking stock's value)? In our view, either of these transactions has "substantially the same effect" as a derivative based on a pass-thru entity. The legislative history might offer examples such as these to clarify the scope of the "substantially the same effect" test.

D. *Interest Computation*

Our Prior Report noted that the underpayment rate is somewhat punitive because it exceeds the borrowing cost of most taxpayers who engage in derivative transactions.[18] A lower interest rate would be more consistent with the objective of equalizing the tax burden on derivatives and the underlying. Our Prior Report suggested the approach of § 1258(d)(2) (*i.e.*, 120% of the applicable federal rate that would have applied under § 1274 to a bond issued at inception of the COT and having the same maturity as the COT).[19] On the other hand, because the Bill allows continued deferral of long-term capital gains, there is a "rough justice," admittedly, in using the higher rate for the Recharacterized Gain.

The Bill's mechanic for computing interest is slightly different from the Prior Bill's approach. In each, interest is computed based on a hypothetical underpayment, *i.e.*, the

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[16](...continued)
derivatives on derivatives, it may wish to indicate in legislative history how it intends that this authority be exercised.

[17] For example, if a taxpayer entered into a total return swap that was, in turn, based on the value of a fixed price forward to acquire a specified partnership interest, the swap could be deemed to have "substantially the same effect" as a swap based directly on the partnership interest.

[18] Prior Report, at 25-26.

[19] Prior Report, at 25. In addition, if the rate is reduced for COTs, the rate under § 6621 should be retained for COTs on PFICs, because the interest charge on the underlying would be based on § 6621. See Prop. Treas. Reg. § 1.1291-4(d).

Recharacterized Gain that is assumed to have been earned, but not taxed, in earlier years. How much Recharacterized Gain is allocated to each year of the COT? Under the Prior Bill, it was ratably allocated.[20] Under the Bill, it is instead allocated as if it had accrued at a constant rate, equal to the applicable federal rate in effect when the COT is settled.[21] To see the difference, assume that the COT lasted for three years and generated thirty-three dollars of Recharacterized Gain. Assume also that the AFR is 10% when the COT is settled. Under the Prior Bill's approach, there would be an eleven-dollar underpayment for each year of the COT. Under the Bill, the underpayments would be approximately ten dollars for the first year, eleven for the second, and twelve for the third.

By giving effect to compounding, the Bill's approach is more generous to the taxpayer because it shifts hypothetical underpayments to later years. For the same reason, the Bill's approach probably is a better approximation of empirical reality, as compounding gives investment growth an exponential character. Yet, the ratable method has the advantage of simplicity, in that it is easier for taxpayers and audit agents to compute. In our view, either approach is reasonable. If the constant rate method is used, though, we recommend an exception for COTs on PFICs; the PFIC regime uses ratable allocation,[22] and taxpayers should not have a tax incentive to shift from PFICs to COTs on PFICs.

E. Coordination with PFIC Regime

1. PFIC Options

As drafted, the Bill would not cover options on PFIC stock (because they do not expose the taxpayer to risk of loss on the PFIC). Those options are governed, instead, by a proposed regulation (not yet finalized) that adds the holding period of the option to the holding period of the underlying PFIC stock.[23] The end result, then, is that the taxpayer does not recognize any gain from exercising the option, but ultimately her profit from this period will give rise to ordinary income and will be subject to an interest charge. A QEF election is not available to holders of options on PFIC stock.[24]

As we observed in our Prior Report, given the similar policy objectives of the Bill and the proposed PFIC option rule, the tax treatment arguably should be aligned so that forwards

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[20] Ratable allocation is also used in the Administration Proposal and, as discussed in Part IV.E.2 below, in the PFIC regime.

[21] Proposed § 1260(b)(2).

[22] See 1291(a)(1)(A); Prop. Treas. Reg. § 1.1291-2(e).

[23] Prop. Treas. Reg. § 1.1291-1(h)(3).

[24] Treas. Reg. § 1.1295-1T(d)(4).

and options do not generate different tax consequences.[25] It would be helpful to clarify that the grant of regulatory authority in Proposed § 1260(g) is intended to authorize the Treasury to address COTs on derivatives on PFICs and, more generally, the interaction between Proposed § 1260 and the PFIC regime. Any such treatment might require changes to the proposed PFIC option rule in the regulations under § 1291.

2. *Disparities Between COT and Direct Ownership*

As indicated above, the PFIC regime bases the interest charge on a ratable allocation of gain, whereas the Bill uses a constant rate method. For COTs on PFICs, we recommend the former method, even if the latter is retained for other COTs. Moreover, a taxpayer who holds an interest in a PFIC (absent a QEF election) will be taxed at ordinary income rates for all her gains. Under the Bill as drafted, a COT would generate short-term capital gain.[26] As indicated above, we recommend that Recharacterized Gain under Proposed § 1260 be treated as ordinary income. If this recommendation is not accepted, we suggest the use of regulatory authority to treat as ordinary income any Recharacterized Gain from COTs on PFICs.

3. *QEF Elections*

Unless the Bill is clarified, COTs on PFICs the taxpayer once owned – and, importantly, on which she made a QEF election – could receive better tax treatment than COTs on PFICs that the taxpayer never owned. Assume the taxpayer used to be an investor in a PFIC and made a QEF election. Some years after she has sold the PFIC, she enters into a COT on the same PFIC. Under the PFIC regime, a QEF election is irrevocable, and applies even to new investments in the same PFIC.[27] As a result, the QEF election affects the COT, albeit indirectly. When the taxpayer computes her "net underlying long-term capital gain," she must compute the long-term capital gain "the taxpayer would have had if the [PFIC] had been acquired for fair market value on the date which transaction was opened and sold for fair market value on the date such transaction was closed."[28] Under this language, the taxpayer arguably is entitled to compute her gain as if she owned the PFIC directly, and thus had a QEF election in effect. As a result, she would have net underlying long-term capital gain whereas, without a QEF election, she would not. Moreover, the taxpayer would be able to defer her long-term capital gain under the COT –

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[25] Prior Report, at 19 n.38.

[26] The taxpayer would have no "net underlying long-term capital gain" because ownership of the PFIC would not generate any long-term capital gain. As a result, all her gains on the COT would be recharacterized; under the Bill (in contrast to the Administration's Proposal), Recharacterized Gain is treated as short-term capital gain.

[27] See § 1295; Prop. Treas. Reg. § 1.1295-1(b)(2).

[28] Proposed § 1260(e)

something she could not do under an actual QEF election. These residual benefits of a prior QEF election would not be available to taxpayers who have never made one (*e.g.*, because they have never owned the relevant PFIC). As drafted, the Bill does not allow "constructive owners" of a PFIC to make a QEF election upon entering into a COT.[29] To rectify this disparity, the legislative history should provide that, in computing net underlying long-term capital gains for COTs on a PFIC, prior QEF elections should be ignored.

Although "back door" QEF elections should not be permitted because of their limited availability and deferral opportunities, a QEF election arguably should be allowed at the time taxpayers enter into a COT on a PFIC. Because this treatment would have been available to a direct owner, it does not seem abusive to allow it to a "constructive" owner. Yet, as our Prior Report observed, allowing a QEF election on a COT would introduce complexity.[30] For example, the COT is likely to be more leveraged than a direct purchase (*i.e.*, because a nonprepaid forward contract includes a time-value component in the forward price), and the treatment of this leverage component would have to be resolved.[31] (For example, it might be appropriate to allow the taxpayer an interest deduction based on the implied interest rate, subject to investment interest limitations). Coordination between the tax treatment of the "actual" and "constructive" owners might be necessary as well. On the other hand, if the "actual owner" is a securities dealer or other tax-indifferent party, the QEF election would offer it little benefit, and so it should not be costly to allow two QEF elections; if the "actual owner" is not a tax-indifferent party, moreover, the original abuse targeted by the Bill – shifting burdensome tax consequences to a tax-indifferent party – would not be implicated. Compared to current law, where one party would have a QEF election and the other would have the deferral and capital gain associated with a derivative position, the government would *gain* revenue by allowing two QEF elections[32] – although, admittedly, the revenue gain would be smaller than if the

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29 Note that the PFIC regime authorizes "indirect" holders to make a QEF election, but this term describes holders who own the stock through a corporation or pass-thru entity. See Prop. Treas. Reg. § 1.1291-1(b)(8); Prop. Treas. Reg. § 1.1295-1T(j). A QEF election does not apply to an option to buy stock of a PFIC, see Treas. Reg. § 1.1295-1T(b)(2)(iii), and a COT on a PFIC likewise seems not to be covered.

30 See Prior Report, at 19; see also T.D. 8750, 63 Fed. Reg. 6 (Jan. 2, 1998) (in explaining why no QEF election was available to PFIC option holders, the Treasury Department expressed concern that the election "would present serious computational issues and would be administratively burdensome").

31 It would also be necessary to resolve, for example, which party or parties would be entitled to the information statement from the PFIC and how the retroactive election rules would apply.

32 The assumption here is that the PFIC has a pretax profit. If it generates losses, these would be deferred under either the QEF election, see § 1293(a) (providing (continued...)

government allowed only one QEF election and imposed recharacterization and the interest charge on the other taxpayer. Given the difficulty of these issues, it would not be appropriate to resolve them in the legislation. However, we recommend that the grant of regulatory authority to Treasury reference the QEF election issue. Similarly, the grant of regulatory authority should authorize coordination of any mark-to-market election for PFIC COTs with the mark-to-market election for marketable stock under the PFIC rules.

F. Constructive Ownership Transactions Held by Pass-Thru Entities

Taxpayers arguably could avoid the Bill, as drafted, by interposing a pass-thru entity that holds the derivative. For example, assume a U.S. taxpayer ("U.S. Holder") buys an interest in a PFIC ("PFIC" and "PFIC Interest," as the case may be) on January 1, 2000 and makes a QEF election. On the same date, the PFIC enters into a COT (the "COT"), a forward to acquire a hedge fund interest in two years (*i.e.*, on December 31, 2002). Assume the COT is profitable. We note two potential gaps in the regime.

First, assume the taxpayer still owns the PFIC Interest when the COT matures. The COT regime will be only partially effective. Because the PFIC itself is likely to be outside U.S. taxing jurisdiction, the COT regime can have effect only through the U.S. Holder. Yet under current law, although a QEF election passes through *changes in character* triggered by the COT regime, it does not pass through interest charges. Under § 1293(a)(1)(A), electing PFIC shareholders must include their pro rata share of the PFIC's ordinary earnings and net capital gain, but this provision does not assign liability for the pro-rata share of interest charges or other penalty taxes.[33]

In addition, assume the taxpayer sells the PFIC interest on December 30, 2002, the day before the COT matures. As an economic matter, a portion of her gain on this sale would derive from the COT (assuming the latter was profitable). However, this gain arguably is not recharacterized because the COT regime has not been triggered yet. Nor will the COT regime necessarily affect the new owner (*e.g.*, if she is a foreign person).[34]

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[32](...continued)
for inclusion of gains but not losses), or under the treatment of derivatives under current law.

[33] Similarly, although the CFC and FPHC provisions would require a U.S. shareholder to include her pro rata share of ordinary income (including Recharacterized Gain), neither has a clear mechanism for including the pro rata share of an interest charge.

[34] This potential loophole also arises if the COT is held in other pass-thru entities, such as partnerships, RICs, REITs, and FPHCs. Yet the problem does not arise if the COT is held in a PFIC, and the PFIC interest is subject to either mark-to-

(continued...)

We do not recommend addressing these gaps at the entity level by, for example, collecting the interest charges from the pass-thru entity holding the COT. As indicated above, foreign pass-thrus such as PFICS, FPHCs, and FICs could be outside U.S. taxing jurisdiction. In the case of a PFIC, moreover, an entity-level interest charge is not always necessary. If the owner of the PFIC interest has elected to mark it to market, there is no tax deferral and thus no need for an interest charge; gain on the COT increases the PFIC interest's fair market value and, thus, is taxed annually. Likewise, under traditional treatment of a PFIC (*i.e.*, no mark-to-market election or QEF election), the holder pays an interest charge upon disposing of her PFIC interest. Gains on the COT would increase the sale price of the PFIC interest and thus would be subject to an interest charge, albeit indirectly. Only when the holder of the PFIC interest has made a QEF election, then, does the interest charge need to be imposed. Finally, although the jurisdictional issue does not apply to U.S. pass-thru entities, they are not ordinarily taxpayers and so adding a special tax could be cumbersome.[35] Having different approaches for foreign and U.S. pass-thrus, moreover, would add complexity.

Accordingly, we recommend a shareholder-level solution for potentially abusive cases, in which the interest charge and tax on Recharacterized Gain is collected from the holder of the pass-thru interest, rather than from the entity. For example, holding an interest in a pass-thru entity that holds a COT could be treated as having "substantially the same effect" as holding a COT directly. Yet this approach arguably would not find a COT if the pass-thru holds a robust portfolio of other assets along with its COTs — at least, unless the statute or legislative history signals that bifurcation is appropriate in such a circumstance. Alternatively, the regime could employ an "indirect disposition" approach, in which disposition of a pass-thru interest (*e.g.*, in a taxable transaction) could be treated as a disposition of COTs held by the pass-thru.[36] Appropriate adjustments should then be made so that the purchaser of the pass-thru interest does not bear an interest charge for periods as to which the prior holder has already paid an interest charge.[37]

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[34](...continued)
market accounting or the traditional interest charge upon selling the PFIC interest; in the latter two cases, as discussed below, COT gains are reflected in the PFIC interest's fair market value, which is either taxed annually (under a mark-to-market election) or is subject to an interest charge.

[35] *Cf.* Treas. Reg. § 1.460-6(d)(4)(i) (under look-back rule for long-term contracts, applying simplified marginal impact method to certain pass-thru entities at entity level). Unlike partnerships, RICS and REITS theoretically can be taxpayers, although the regimes are designed to offer flow-through treatment by providing entity-level deductions.

[36] Analogies include the indirect disposition regime of § 1298(b)(5) and Prop. Treas. Reg. § 1.1291-3(e), as well as the "hot asset" rules of §751.

[37] For example, assume that a partnership holds a COT with a two-year term that

(continued...)

A shareholder-level solution could introduce significant complexity and administrative cost, though. For example, what if the taxpayer sells her pass-thru interests at a loss (*e.g.*, because the entity's losses on other investments outweigh its profits from COTs)?[38] Absent reporting by the entity, moreover, the holder of the pass-thru interest may not know which of the entity's positions, if any, are COTs. Indeed, under current law, pass-thru entities ordinarily are not required to report the amount of their unrealized appreciation (from COTs or otherwise).[39] Yet the holder would need this number if sale of her pass-thru interests is treated as an indirect disposition of the COT.

There is a tradeoff, then, between sealing gaps in the COT regime, on one hand, and avoiding significant complexity and onerous reporting obligations, on the other. As a way to manage the tradeoff, indirect dispositions might be triggered only when the pass-thru entity's COTs represent more than a minimum notional amount (or percentage of its assets), or when taxpayers use a pass-thru entity with intent to avoid the COT regime.[40]

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[37](...continued)
began on February 1, 2000, while Jack, a U.S. taxpayer, owns a partnership interest. On January 30, 2002, the day before the COT matures, Jack sells his partnership interest to Jill, who is also a U.S. taxpayer. Assuming Jack is treated as making an indirect disposition of the COT, and thus is subject to an interest charge for his 2000 and 2001 tax years, it seems inappropriate to impose this interest charge on Jill as well. In other words, the interest charge should be based on the taxpayer's own holding period in the entity, rather than on the entity's holding period in the COT.

38 For example, assume the taxpayer purchases for $100 an interest in a partnership that has two assets: a COT and a share of common stock, each of which is worth $50. If the COT appreciates by $10 and the common stock depreciates by $20, the taxpayer could sell the partnership interest for $90 — at a $10 loss. Should the $10 of COT gain still be subject to an interest charge? To do so imposes onerous computations on taxpayers and may be viewed as unfair, given that the asset as a whole was not profitable; indeed, if the entity becomes bankrupt, profits from the COT arguably inhere to the benefit of the entity's creditors, rather than its equity-holders. On the other hand, the taxpayer would have owed an interest charge if she held the COT and common stock separately, and introduction of an entity arguably should not be sufficient to avoid the COT regime. It would be helpful for Congress to provide guidance on this issue.

39 See, *e.g.*, Treas. Reg. § 1.1293-1T(a)(2) (offering various options for reporting of "net capital gain," none of which include reporting of unrealized appreciation).

40 *Cf.* § 1092(d)(1) (stock may be part of a straddle if it is "of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder"); Treas. Reg. § 1.446-3(i) ("If a taxpayer enters into a

(continued...)

G. *Tax-Exempts and Foreigners*

The Bill applies only if the taxpayer "has gain . . . and such gain would (without regard to this section) be treated as a long term capital gain."[41] Because tax exempts and foreigners ordinarily would not recognize any gain on a derivative, we assume the Bill does not apply to them (*e.g.*, if a tax exempt invests in derivatives instead of in underlyings that generate UBTI, or if a foreigner invests in derivatives instead of in underlyings that generate effectively connected income or income subject to withholding). As our Prior Report stated, we agree the Bill is not the right vehicle for addressing these transactions.[42] Yet the language quoted above is not entirely free of ambiguity. We read the phrase "treated as long term capital gain" to mean "taxed" as such. Substituting the phrase "taxed" for "treated" would add clarity.[43] Alternatively, the legislative history might clarify that such a meaning is intended.

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[40](...continued)
transaction with a principal purpose of applying the rules of this section to produce a material distortion of income, the commissioner may depart from the rules of this section as necessary to reflect the appropriate timing of income and deductions from the transaction."); Treas. Reg. § 1.7704-1(h)(3) (anti-abuse rule in which partners in an upper-tier partnership are deemed to be partners of lower-tier partnership if "a principal purpose of the use of the tiered arrangement is to permit the partnership to satisfy the 100-partner limitation").

[41] See Proposed § 1260(a).

[42] See Prior Report, at 9 n. 15 (urging caution in considering extensions of constructive ownership principles beyond those contemplated by the Bill, including § 514 and cross-border withholding); see also NYSBA 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).

[43] While taxpayers who accept physical delivery on a derivative are neither "treated" nor "taxed" as if they have long-term capital gain, Proposed § 1260(f) addresses this issue.

Appendix

106th CONGRESS

1st SESSION

H. R. 1703

IN THE HOUSE OF REPRESENTATIVES

May 5, 1999

Mr. NEAL of Massachusetts introduced the following bill; which was referred to the Committee on Ways and Means

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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 Representatives of the United States of America in Congress assembled,

SECTION 1. 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 asset 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 tax imposed by this chapter for such taxable year shall be increased by the amount of interest determined under paragraph (2) with respect to each prior taxable year during any portion of which 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) AMOUNT OF INTEREST.—The amount of interest determined under this paragraph with respect to a prior taxable year is the amount of interest which would have been imposed under section 6601 on the underpayment of tax

for such year which would have resulted if the gain (which is treated as short-term gain by reason of subsection (a)(1)) had been included in gross income in the taxable years in which it accrued (determined by treating the gain as accruing at a constant rate equal to the applicable Federal rate as in effect on the day the transaction closed). The period during which such interest shall accrue shall end on the due date (without extensions) for the return of tax imposed by this chapter for the taxable year in which such transaction closed.

"(3) APPLICABLE FEDERAL RATE.—For purposes of paragraph (2), the applicable Federal rate is the applicable Federal rate determined under 1274(d) (compounded semiannually) which would apply to a debt instrument with a term equal to the period the transaction was open.

"(4) 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 this chapter, or

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

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

"(1) IN GENERAL.—The term `financial asset' means—

"(A) any equity interest in any pass-thru entity, and

"(B) to the extent provided in regulations—

"(i) any debt instrument, and

"(ii) any stock in a corporation which is not a pass-thru entity.

"(2) PASS-THRU ENTITY.—For purposes of paragraph (1), the term `pass-thru entity' means—

"(A) a regulated investment company,

"(B) a real estate investment trust,

"(C) an S corporation,

"(D) a partnership,

"(E) a trust,

"(F) a common trust fund,

"(G) a passive foreign investment company (as defined in section 1297),

"(H) a foreign personal holding company, and

"(I) a foreign investment company (as defined in section 1246(b)).

"(d) CONSTRUCTIVE OWNERSHIP TRANSACTION.—For purposes of this section—

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

"(A) holds a long position under a notional principal contract with respect to the financial asset,

"(B) enters into a forward or futures contract to acquire the financial asset,

"(C) is the holder of a call option, and is the grantor of a put option, with respect to the financial asset and such options have substantially equal strike prices and substantially contemporaneous maturity dates, 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 UNDER NOTIONAL PRINCIPAL CONTRACT.—A person shall be treated as holding a long position under a notional principal contract with respect to any financial asset 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 financial asset 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 financial asset.

"(4) FORWARD CONTRACT.—The term 'forward contract' means any contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.

"(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 asset, the term 'net underlying long-term capital gain' means the aggregate net capital gain that the taxpayer would have had if—

"(1) the financial asset had been acquired for fair market value on the date such transaction was opened and sold for fair market value 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 asset shall be treated as zero unless the amount thereof is established by clear and convincing evidence.

"(f) SPECIAL RULE WHERE TAXPAYER TAKES DELIVERY.—Except as provided in regulations prescribed by the Secretary, if a constructive ownership transaction is closed by reason of taking delivery, this section shall be applied as if the taxpayer had sold all the contracts, options, or other positions which are part of such transaction for fair market value on the closing date. The amount of gain recognized under the preceding sentence shall not exceed the amount of gain treated as short-term gain under subsection (a). Proper adjustments shall be made in the amount of any gain or loss subsequently realized for gain recognized under this subsection.

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

regulations permitting taxpayers to mark to market constructive ownership transactions in lieu of applying this section.".

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

"Sec. 1260. Gains from constructive ownership transactions.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to gains recognized after the date of the enactment of this Act; except that such amendments shall not apply to transactions entered into before February 5, 1998, and not extended or substantially modified on or after such date.