New York State Bar Association

NYSBA

One Elk Street, Albany, New York 12207 • 518/463-3200 • http://www.nysba.org

TAX SECTION

2000-2001 Executive Committee

ROBERT H. SCARBOROUGH
Chair
Freshfields
520 Madison Avenue
34th Floor
New York, NY 10022
212/277-4045
ROBERT A. JACOBS
First Vice-Chair
212/530-5664
SAMUEL J. DIMON
Second Vice-Chair
212/450-4037
ANDREW N. BERG
Secretary
212/909-6288
COMMITTEE CHAIRS:
Bankruptcy and Operating Losses
Stuart J. Goldring
Dale L. Ponikvar
Capitalization and Cost Recovery
Joel Scharfstein
Alan J. Tarr
Character, Gains & Losses
Michael S. Farber
Erika W. Nijenhuis
CLE and Pro Bono
James A. Locke
Elizabeth A. Smith
Compliance, Practice & Procedure
Robert S. Fink
Arnold Y. Kapiloff
Consolidated Returns
Deborah L. Paul
Lawrence M. Garrett
Corporations
Lewis R. Steinberg
Diana L. Wollman
Employee Benefits
David A. Pratt
Andrew W. Stumpff
Estates and Trusts
Mildred Kalik
Carlyn S. McCaffrey
Financial Instruments
David S. Miller
David M. Schizer
Financial Intermediaries
Yaron Z. Reich
Andrew P. Solomon
Foreign Activities of U.S. Taxpayers
Peter H. Blessing
Emily S. McMahon
Individuals
Kimberly S. Blanchard
Lisa A. Levy
Multistate Tax Issues
Robert E. Brown
Paul R. Comeau
New York City Taxes
Robert J. Levinsohn
William B. Randolph
New York State Franchise and Income Taxes
Maria T. Jones
Arthur R. Rosen
New York State Sales and Misc.
John P. Dugan
Hollis L. Hyans
Partnerships
William B. Brannan
Patrick C. Gallagher
Pass-Through Entities
Janet Beth Konns
Paul R. Wysocki
Real Property
Elliot Pisem
Lary S. Wolf
Reorganizations
Kathleen L. Ferrell
Jodi J. Schwartz
Tax Accounting
Marc L. Silberberg
Linda Z. Swartz
Tax Exempt Bonds
Linda L. D'Onofrio
John T. Lutz
Tax Exempt Entities
Dickson G. Brown
Michelle P. Scott
Tax Policy
David P. Hariton
Victor Zonana
U.S. Activities of Foreign Taxpayers
James Ross MacDonald
David R. Sicular

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:
Peter v. Z. Cobb
M. Carr Ferguson
Sherwin Kamin
Charles I. Kingson
Glen A. Kohl
Sherry S. Kraus
Stuart E. Leblang
Donald C. Lubick
Charles M. Morgan, III
David M. Rievman
David H. Schnabel
Robert T. Smith
Dana L. Trier
Eugene L. Vogel
David E. Watts

March 17, 2000

The Honorable William V. Roth, Jr.
Chair Senate Finance Committee
United States Senate
104 Hart Senate Office Building
Washington, D.C. 20510

Dear Chairman Roth:

Enclosed please find a report of the New York State Bar Association Tax Section, which discusses the Clinton Administration's Fiscal Year 2001 Budget proposals relating to straddles. The Administration proposes that Congress (1) repeal the so-called "stock exception" to the straddle rules (the "Stock-Exception Proposal"), (2) provide that an issuer's obligations under a debt instrument linked to the value of personal property held by the issuer may constitute a leg of a straddle (the "Debt-Straddle Proposal"), (3) provide that loss realized on a straddle position would be capitalized into the basis of all potentially offsetting positions, first to those with the greatest amount of unrealized gain, and then *pro rata* (the "Capitalization Proposal"), (4) provide that on physical settlement of an option or forward contract, the seller would "mark to market" the contract for purposes of the straddle rules and allocate any resulting loss in accordance with the Capitalization Proposal (the "Mark-to-Market Proposal") and (5) provide rules for determining when debt is "straddle-related," in which case interest on the debt would be subject to capitalization under Section 263(g) (the "263(g) Proposal").

The report generally favors aspects of each proposal, with important qualifications. In particular:

(1) The report supports the Stock-Exception Proposal to the extent that it provides that holding stock directly and entering into a short sale with respect to substantially identical stock is a straddle. If, however, the stock exception is to be repealed in its entirety, the report strongly favors

FORMER CHAIRS OF SECTION:
Samuel Brodsky
Thomas C. Plowden-Wardlaw
Edwin M. Jones
Hon. Hugh R. Jones
Peter Miller
John E. Morrissey, Jr.
Charles E. Heming
Ralph O. Winger
Martin D. Ginsburg
Peter L. Faber
Hon. Renato Beghe
Alfred D. Youngwood
Gordon D. Henderson
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Dale S. Collinson
Richard G. Cohen
Donald Schapiro
Herbert L. Camp
William L. Burke
Arthur A. Feder
James M. Peaslee
John A. Corry
Peter C. Canellos
Michael L. Schler
Carolyn Joy Lee
Richard L. Reinhold
Richard O. Loengard
Steven C. Todrys
Harold R. Handler

Do the Public Good • Volunteer for Pro Bono

guidance on Congress' view as to when a taxpayer's stock holdings and other positions constitute a straddle.

(2) The report supports the Debt-Straddle Proposal.

(3) The report generally supports the Capitalization Proposal to the extent that it proposes to replace the straddle loss deferral rule with a capitalization rule. The report strongly disagrees, however, with the proposed treatment of "unbalanced straddles," which seems uneconomic and harsh.

(4) Provided that the Capitalization Proposal operates fairly, the report supports the Mark-to-Market Proposal.

(5) The report supports much of what is contemplated by the 263(g) Proposal, while suggesting clarifications as to when debt should be deemed "straddle related."

In addition to responding to the Administration's proposals, the report suggests other changes or clarifications to the straddle rules, including expanding the concept of a "loss" subject to deferral under the straddle rules, limiting the application of the straddle holding-period rules to positions as to which the risk of loss is "substantially diminished," repealing the qualified covered call rules, and reviewing the continuing relevance of the short sale rules of Section 1233. Finally, the report makes a number of technical observations, including proposals to clarify the definition of a "straddle position" and to expand the concept of a related party for straddle purposes.

We recognize the possibility that tax legislation addressing the straddle rules will not be enacted this year. We hope that in such a case Treasury will find aspects of the report useful in exercising its regulatory authority to interpret those rules.

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

Very truly yours,

Samuel J. Dimon

Enclosure

cc: Hon. Daniel P. Moynihan
Ranking Minority Member
Senate Finance Committee
United States Senate

Lindy L. Paull, Esq.,
Chief of Staff
Joint Committee On Taxation

Mark Prater, Esq.
Majority Chief Tax Counsel
Senate Finance Committee

Russell W. Sullivan, Esq.
Minority Chief Tax Counsel
Senate Finance Committee

New York State Bar Association

NYSBA

One Elk Street, Albany, New York 12207 • 518/463-3200 • http://www.nysba.org

TAX SECTION

2000-2001 Executive Committee

ROBERT H. SCARBOROUGH
Chair
Freshfields
520 Madison Avenue
34th Floor
New York, NY 10022
212/277-4045
ROBERT A. JACOBS
First Vice-Chair
212/530-5664
SAMUEL J. DIMON
Second Vice-Chair
212/450-4037
ANDREW N. BERG
Secretary
212/909-6288
COMMITTEE CHAIRS:
Bankruptcy and Operating Losses
Stuart J. Goldring
Dale L. Ponikvar
Capitalization and Cost Recovery
Joel Scharfstein
Alan J. Tarr
Character, Gains & Losses
Michael S. Farber
Erika W. Nijenhuis
CLE and Pro Bono
James A. Locke
Elizabeth A. Smith
Compliance, Practice & Procedure
Robert S. Fink
Arnold Y. Kapiloff
Consolidated Returns
Deborah L. Paul
Lawrence M. Garrett
Corporations
Lewis R. Steinberg
Diana L. Wollman
Employee Benefits
David A. Pratt
Andrew W. Stumpff
Estates and Trusts
Mildred Kalik
Carlyn S. McCaffrey
Financial Instruments
David S. Miller
David M. Schizer
Financial Intermediaries
Yaron Z. Reich
Andrew P. Solomon
Foreign Activities of U.S. Taxpayers
Peter H. Blessing
Emily S. McMahon
Individuals
Kimberly S. Blanchard
Lisa A. Levy
Multistate Tax Issues
Robert E. Brown
Paul R. Comeau
New York City Taxes
Robert J. Levinsohn
William B. Randolph
New York State Franchise and Income Taxes
Maria T. Jones
Arthur R. Rosen
New York State Sales and Misc.
John P. Dugan
Hollis L. Hyans
Partnerships
William B. Brannan
Patrick C. Gallagher
Pass-Through Entities
Janet Beth Korins
Paul R. Wysocki
Real Property
Elliot Pisem
Lary S. Wolf
Reorganizations
Kathleen L. Ferrell
Jodi J. Schwartz
Tax Accounting
Marc L. Silberberg
Linda Z. Swartz
Tax Exempt Bonds
Linda L. D'Onofrio
John T. Lutz
Tax Exempt Entities
Dickson G. Brown
Michelle P. Scott
Tax Policy
David P. Hariton
Victor Zonana
U.S. Activities of Foreign Taxpayers
James Ross MacDonald
David R. Sicular

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:
Peter v. Z. Cobb
M. Carr Ferguson
Sherwin Kamin
Charles I. Kingson
Glen A. Kohl
Sherry S. Kraus
Stuart E. Leblang
Donald C. Lubick
Charles M. Morgan, III
David M. Rievman
David H. Schnabel
Robert T. Smith
Dana L. Trier
Eugene L. Vogel
David E. Watts

March 17, 2000

The Honorable Jonathan Talisman
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
Room 1330 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Talisman:

Enclosed please find a report of the New York State Bar Association Tax Section, which discusses the Clinton Administration's Fiscal Year 2001 Budget proposals relating to straddles. The Administration proposes that Congress (1) repeal the so-called "stock exception" to the straddle rules (the "Stock-Exception Proposal"), (2) provide that an issuer's obligations under a debt instrument linked to the value of personal property held by the issuer may constitute a leg of a straddle (the "Debt-Straddle Proposal"), (3) provide that loss realized on a straddle position would be capitalized into the basis of all potentially offsetting positions, first to those with the greatest amount of unrealized gain, and then *pro rata* (the "Capitalization Proposal"), (4) provide that on physical settlement of an option or forward contract, the seller would "mark to market" the contract for purposes of the straddle rules and allocate any resulting loss in accordance with the Capitalization Proposal (the "Mark-to-Market Proposal") and (5) provide rules for determining when debt is "straddle-related," in which case interest on the debt would be subject to capitalization under Section 263(g) (the "263(g) Proposal").

The report generally favors aspects of each proposal, with important qualifications. In particular:

(1) The report supports the Stock-Exception Proposal to the extent that it provides that holding stock directly and entering into a short sale with respect to substantially identical stock is a straddle. If, however, the stock exception is to be repealed in its entirety, the report strongly favors guidance on Congress' view as to when a taxpayer's stock holdings and other positions constitute a straddle.

FORMER CHAIRS OF SECTION:
Samuel Brodsky
Thomas C. Plowden-Wardlaw
Edwin M. Jones
Hon. Hugh R. Jones
Peter Miller
John E. Morrissey, Jr.
Charles E. Heming
Ralph O. Winger
Martin D. Ginsburg
Peter L. Faber
Hon. Renato Beghe
Alfred D. Youngwood
Gordon D. Henderson
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Dale S. Collinson
Richard G. Cohen
Donald Schapiro
Herbert L. Camp
William L. Burke
Arthur A. Feder
James M. Peaslee
John A. Corry
Peter C. Canellos
Michael L. Schler
Carolyn Joy Lee
Richard L. Reinhold
Richard O. Loengard
Steven C. Todrys
Harold R. Handler

Do the Public Good • Volunteer for Pro Bono

(2) The report supports the Debt-Straddle Proposal.

(3) The report generally supports the Capitalization Proposal to the extent that it proposes to replace the straddle loss deferral rule with a capitalization rule. The report strongly disagrees, however, with the proposed treatment of "unbalanced straddles," which seems uneconomic and harsh.

(4) Provided that the Capitalization Proposal operates fairly, the report supports the Mark-to-Market Proposal.

(5) The report supports much of what is contemplated by the 263(g) Proposal, while suggesting clarifications as to when debt should be deemed "straddle related."

In addition to responding to the Administration's proposals, the report suggests other changes or clarifications to the straddle rules, including expanding the concept of a "loss" subject to deferral under the straddle rules, limiting the application of the straddle holding-period rules to positions as to which the risk of loss is "substantially diminished," repealing the qualified covered call rules, and reviewing the continuing relevance of the short sale rules of Section 1233. Finally, the report makes a number of technical observations, including proposals to clarify the definition of a "straddle position" and to expand the concept of a related party for straddle purposes.

We recognize the possibility that tax legislation addressing the straddle rules will not be enacted this year. We hope that in such a case Treasury will find aspects of the report useful in exercising its regulatory authority to interpret those rules.

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

Very truly yours,

Samuel J. Dimon

Enclosure

cc: Eric Solomon, Esq.
Acting Deputy Assistant Secretary (Tax Policy)

Joseph M. Mikrut, Esq.
Tax Legislative Counsel

Jeffrey W. Maddrey, Esq.
Associate Tax Legislative Counsel

New York State Bar Association
NYSBA One Elk Street, Albany, New York 12207 • 518/463-3200 • http://www.nysba.org

TAX SECTION
2000-2001 Executive Committee
ROBERT H. SCARBOROUGH Chair Freshfields 520 Madison Avenue 34th Floor New York, NY 10022 212/277-4045
ROBERT A. JACOBS First Vice-Chair 212/530-5664
SAMUEL J. DIMON Second Vice-Chair 212/450-4037
ANDREW N. BERG Secretary 212/909-6288
COMMITTEE CHAIRS:
Bankruptcy and Operating Losses: Stuart J. Goldring, Dale L. Ponikvar
Capitalization and Cost Recovery: Joel Scharfstein, Alan J. Tarr
Character, Gains & Losses: Michael S. Farber, Erika W. Nijenhuis
CLE and Pro Bono: James A. Locke, Elizabeth A. Smith
Compliance, Practice & Procedure: Robert S. Fink, Arnold Y. Kapiloff
Consolidated Returns: Deborah L. Paul, Lawrence M. Garrett
Corporations: Lewis R. Steinberg, Diana L. Wollman
Employee Benefits: David A. Pratt, Andrew W. Stumpff
Estates and Trusts: Mildred Kalik, Carlyn S. McCaffrey
Financial Instruments: David S. Miller, David M. Schizer
Financial Intermediaries: Yaron Z. Reich, Andrew P. Solomon
Foreign Activities of U.S. Taxpayers: Peter H. Blessing, Emily S. McMahon
Individuals: Kimberly S. Blanchard, Lisa A. Levy
Multistate Tax Issues: Robert E. Brown, Paul R. Comeau
New York City Taxes: Robert J. Levinsohn, William B. Randolph
New York State Franchise and Income Taxes: Maria T. Jones, Arthur R. Rosen
New York State Sales and Misc.: John P. Dugan, Hollis L. Hyans
Partnerships: William B. Brannan, Patrick C. Gallagher
Pass-Through Entities: Janet Beth Korins, Paul R. Wysocki
Real Property: Elliot Pisem, Lary S. Wolf
Reorganizations: Kathleen L. Ferrell, Jodi J. Schwartz
Tax Accounting: Marc L. Silberberg, Linda Z. Swartz
Tax Exempt Bonds: Linda L. D'Onofrio, John T. Lutz
Tax Exempt Entities: Dickson G. Brown, Michelle P. Scott
Tax Policy: David P. Hariton, Victor Zonana
U.S. Activities of Foreign Taxpayers: James Ross MacDonald, David R. Sicular

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:
Peter v. Z. Cobb, M. Carr Ferguson, Sherwin Kamin, Charles I. Kingson, Glen A. Kohl, Sherry S. Kraus, Stuart E. Leblang, Donald C. Lubick, Charles M. Morgan, III, David M. Rievman, David H. Schnabel, Robert T. Smith, Dana L. Trier, Eugene L. Vogel, David E. Watts

March 17, 2000

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Rossotti:

Enclosed please find a report of the New York State Bar Association Tax Section, which discusses the Clinton Administration's Fiscal Year 2001 Budget proposals relating to straddles. The Administration proposes that Congress (1) repeal the so-called "stock exception" to the straddle rules (the "Stock-Exception Proposal"), (2) provide that an issuer's obligations under a debt instrument linked to the value of personal property held by the issuer may constitute a leg of a straddle (the "Debt-Straddle Proposal"), (3) provide that loss realized on a straddle position would be capitalized into the basis of all potentially offsetting positions, first to those with the greatest amount of unrealized gain, and then *pro rata* (the "Capitalization Proposal"), (4) provide that on physical settlement of an option or forward contract, the seller would "mark to market" the contract for purposes of the straddle rules and allocate any resulting loss in accordance with the Capitalization Proposal (the "Mark-to-Market Proposal") and (5) provide rules for determining when debt is "straddle-related," in which case interest on the debt would be subject to capitalization under Section 263(g) (the "263(g) Proposal").

The report generally favors aspects of each proposal, with important qualifications. In particular:

(1) The report supports the Stock-Exception Proposal to the extent that it provides that holding stock directly and entering into a short sale with respect to substantially identical stock is a straddle. If, however, the stock exception is to be repealed in its entirety, the report strongly favors guidance on Congress' view as to when a taxpayer's stock holdings and other positions constitute a straddle.

(2) The report supports the Debt-Straddle Proposal.

FORMER CHAIRS OF SECTION:
Samuel Brodsky, Thomas C. Plowden-Wardlaw, Edwin M. Jones, Hon. Hugh R. Jones, Peter Miller, John E. Morrissey, Jr., Charles E. Heming, Ralph O. Winger, Martin D. Ginsburg, Peter L. Faber, Hon. Renato Beghe, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Dale S. Collinson, Richard G. Cohen, Donald Schapiro, Herbert L. Camp, William L. Burke, Arthur A. Feder, James M. Peaslee, John A. Corry, Peter C. Canellos, Michael L. Schler, Carolyn Joy Lee, Richard L. Reinhold, Richard O. Loengard, Steven C. Todrys, Harold R. Handler

Do the Public Good • Volunteer for Pro Bono

(3) The report generally supports the Capitalization Proposal to the extent that it proposes to replace the straddle loss deferral rule with a capitalization rule. The report strongly disagrees, however, with the proposed treatment of "unbalanced straddles," which seems uneconomic and harsh.

(4) Provided that the Capitalization Proposal operates fairly, the report supports the Mark-to-Market Proposal.

(5) The report supports much of what is contemplated by the 263(g) Proposal, while suggesting clarifications as to when debt should be deemed "straddle related."

In addition to responding to the Administration's proposals, the report suggests other changes or clarifications to the straddle rules, including expanding the concept of a "loss" subject to deferral under the straddle rules, limiting the application of the straddle holding-period rules to positions as to which the risk of loss is "substantially diminished," repealing the qualified covered call rules, and reviewing the continuing relevance of the short sale rules of Section 1233. Finally, the report makes a number of technical observations, including proposals to clarify the definition of a "straddle position" and to expand the concept of a related party for straddle purposes.

We recognize the possibility that tax legislation addressing the straddle rules will not be enacted this year. We hope that in such a case Treasury will find aspects of the report useful in exercising its regulatory authority to interpret those rules.

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

Very truly yours,

Samuel J. Dimon

Enclosure

cc: Hon. Stuart L. Brown
Chief Counsel

Lon B. Smith, Esq.
Assistant Chief Counsel

Michael S. Novey, Esq.
Counsel to Assistant Chief Counsel

New York State Bar Association

NYSBA

One Elk Street, Albany, New York 12207 • 518/463-3200 • http://www.nysba.org

AX SECTION

2000-2001 Executive Committee

ROBERT H. SCARBOROUGH
Chair
Freshfields
520 Madison Avenue
34th Floor
New York, NY 10022
212/277-4045
ROBERT A. JACOBS
First Vice-Chair
212/530-5664
SAMUEL J. DIMON
Second Vice-Chair
212/450-4037
ANDREW N. BERG
Secretary
212/909-6288
COMMITTEE CHAIRS:
Bankruptcy and Operating Losses
Stuart J. Goldring
Dale L. Ponikvar
Capitalization and Cost Recovery
Joel Scharfstein
Alan J. Tarr
Character, Gains & Losses
Michael S. Farber
Erika W. Nijenhuis
CLE and Pro Bono
James A. Locke
Elizabeth A. Smith
Compliance, Practice & Procedure
Robert S. Fink
Arnold Y. Kapiloff
Consolidated Returns
Deborah L. Paul
Lawrence M. Garrett
Corporations
Lewis R. Steinberg
Diana L. Wollman
Employee Benefits
David A. Pratt
Andrew W. Stumpff
Estates and Trusts
Mildred Kalik
Carlyn S. McCaffrey
ancial Instruments
David S. Miller
David M. Schizer
Financial Intermediaries
Yaron Z. Reich
Andrew P. Solomon
Foreign Activities of U.S. Taxpayers
Peter H. Blessing
Emily S. McMahon
Individuals
Kimberly S. Blanchard
Lisa A. Levy
Multistate Tax Issues
Robert E. Brown
Paul R. Comeau
New York City Taxes
Robert J. Levinsohn
William B. Randolph
New York State Franchise and Income Taxes
Maria T. Jones
Arthur R. Rosen
New York State Sales and Misc.
John P. Dugan
Hollis L. Hyans
Partnerships
William B. Brannan
Patrick C. Gallagher
Pass-Through Entities
Janet Beth Korins
Paul R. Wysocki
Real Property
Elliot Pisem
Lary S. Wolf
Reorganizations
Kathleen L. Ferrell
Jodi J. Schwartz
Tax Accounting
Marc L. Silberberg
Linda Z. Swartz
Tax Exempt Bonds
Linda L. D'Onofrio
John T. Lutz
Tax Exempt Entities
Dickson G. Brown
Michelle P. Scott
Tax Policy
David P. Hariton
Victor Zonana
'.S. Activities of Foreign Taxpayers
James Ross MacDonald
David R. Sicular

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:
Peter v. Z. Cobb
M. Carr Ferguson
Sherwin Kamin
Charles I. Kingson
Glen A. Kohl
Sherry S. Kraus
Stuart E. Leblang
Donald C. Lubick
Charles M. Morgan, III
David M. Rievman
David H. Schnabel
Robert T. Smith
Dana L. Trier
Eugene L. Vogel
David E. Watts

March 17, 2000

The Honorable Bill Archer
Chair, House Ways & Means Committee
1236 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer:

Enclosed please find a report of the New York State Bar Association Tax Section, which discusses the Clinton Administration's Fiscal Year 2001 Budget proposals relating to straddles. The Administration proposes that Congress (1) repeal the so-called "stock exception" to the straddle rules (the "Stock-Exception Proposal"), (2) provide that an issuer's obligations under a debt instrument linked to the value of personal property held by the issuer may constitute a leg of a straddle (the "Debt-Straddle Proposal"), (3) provide that loss realized on a straddle position would be capitalized into the basis of all potentially offsetting positions, first to those with the greatest amount of unrealized gain, and then *pro rata* (the "Capitalization Proposal"), (4) provide that on physical settlement of an option or forward contract, the seller would "mark to market" the contract for purposes of the straddle rules and allocate any resulting loss in accordance with the Capitalization Proposal (the "Mark-to-Market Proposal") and (5) provide rules for determining when debt is "straddle-related," in which case interest on the debt would be subject to capitalization under Section 263(g) (the "263(g) Proposal").

The report generally favors aspects of each proposal, with important qualifications. In particular:

(1) The report supports the Stock-Exception Proposal to the extent that it provides that holding stock directly and entering into a short sale with respect to substantially identical stock is a straddle. If, however, the stock exception is to be repealed in its entirety, the report strongly favors guidance on Congress' view as to when a taxpayer's stock holdings and other positions constitute a straddle.

FORMER CHAIRS OF SECTION:
Samuel Brodsky
Thomas C. Plowden-Wardlaw
Edwin M. Jones
Hon. Hugh R. Jones
Peter Miller
John E. Morrissey, Jr.
Charles E. Heming
Ralph O. Winger
Martin D. Ginsburg
Peter L. Faber
Hon. Renato Beghe
Alfred D. Youngwood
Gordon D. Henderson
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Dale S. Collinson
Richard G. Cohen
Donald Schapiro
Herbert L. Camp
William L. Burke
Arthur A. Feder
James M. Peaslee
John A. Corry
Peter C. Canellos
Michael L. Schler
Carolyn Joy Lee
Richard L. Reinhold
Richard O. Loengard
Steven C. Todrys
Harold R. Handler

Do the Public Good • Volunteer for Pro Bono

(2) The report supports the Debt-Straddle Proposal.

(3) The report generally supports the Capitalization Proposal to the extent that it proposes to replace the straddle loss deferral rule with a capitalization rule. The report strongly disagrees, however, with the proposed treatment of "unbalanced straddles," which seems uneconomic and harsh.

(4) Provided that the Capitalization Proposal operates fairly, the report supports the Mark-to-Market Proposal.

(5) The report supports much of what is contemplated by the 263(g) Proposal, while suggesting clarifications as to when debt should be deemed "straddle related."

In addition to responding to the Administration's proposals, the report suggests other changes or clarifications to the straddle rules, including expanding the concept of a "loss" subject to deferral under the straddle rules, limiting the application of the straddle holding-period rules to positions as to which the risk of loss is "substantially diminished," repealing the qualified covered call rules, and reviewing the continuing relevance of the short sale rules of Section 1233. Finally, the report makes a number of technical observations, including proposals to clarify the definition of a "straddle position" and to expand the concept of a related party for straddle purposes.

We recognize the possibility that tax legislation addressing the straddle rules will not be enacted this year. We hope that in such a case Treasury will find aspects of the report useful in exercising its regulatory authority to interpret those rules.

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

Very truly yours,

Samuel J. Dimon

Enclosure

cc: Hon. Charles B. Rangel
Ranking Minority Member
House Ways & Means Committee
United States House of Representatives

Lindy L. Paull, Esq.,
Chief of Staff
Joint Committee On Taxation

James D. Clark, Esq.
Majority Chief Tax Counsel
House Ways & Means Committee

John Buckley, Esq.
Democratic Chief Tax Counsel
House Ways & Means Committee

NEW YORK STATE BAR ASSOCIATION TAX SECTION

—

REPORT ON PROPOSED "STRADDLE" LEGISLATION

March 17, 2000

Introduction[1]

This report is prompted by the proposed "straddle" legislation outlined in the Administration's Fiscal Year 2001 Revenue Proposals. This proposal, which is significantly more specific and far-reaching than prior unsuccessful legislative initiatives in 1997 and 1999 regarding the straddle rules, encompasses five interrelated changes that would "modify and clarify" the straddle rules (each referred to hereafter as a "Proposal"):[2]

(1) The first Proposal (the "Stock-Exception Proposal") would repeal the so-called "stock exception" to the straddle rules. This Proposal clearly contemplates that holding actively traded stock and entering into a short sale of that stock should constitute a straddle. It is less clear to what extent this Proposal also contemplates repealing or otherwise modifying other straddle rules related to stock, such as the "qualified covered call" regime or current rules defining "substantially similar or related property" that constitutes a straddle with respect to the taxpayer's direct ownership of stock.

(2) The second Proposal (the "Debt-Straddle Proposal") would provide that if a taxpayer issues a debt instrument one or more payments on which are linked to the value of personal property, the taxpayer's obligation under the debt instrument is an interest in the personal property and may constitute a leg of a straddle.

(3) The third Proposal (the "Capitalization Proposal") would provide that loss realized on one leg of a straddle would be capitalized into the offsetting leg of the straddle. For this purpose, the Capitalization Proposal would allocate the realized loss among all potentially offsetting positions, first to those positions with the greatest amount of unrealized gain, and then *pro rata*. Thus, for instance, if a taxpayer held 1,000 shares of XYZ stock and entered into a "collar" with respect to 100 shares of the XYZ stock, any loss realized on cash-settlement of the collar would be allocated among the 1,000 shares held by the taxpayer, first to the lowest-

[1] The principal author of this Report is Michael Farber, with substantial assistance from Sam Dimon. Helpful comments were received from Andrew Berg, Lucy Farr, Harold Handler, David Hariton, Robert Jacobs, Glen Kohl, Richard Loengard, David Miller, Charles Morgan, Erika Nijenhuis, Richard Reinhold, David Schizer, Michael Schler, Andrew Solomon, Dana Trier and Paul Wysocki.

[2] This Report does not address the extent to which each of the five topics addressed in the Administration's proposal is better described as a "modification" or "clarification" of current law.

basis shares (until the basis in all 1,000 shares is equalized) and then *pro rata* among all 1,000 shares.

(4) Under the fourth Proposal (the "Mark-to-Market Proposal"), immediately prior to physical settlement of an option or forward contract on personal property, solely for purposes of the straddle rules the taxpayer delivering the personal property would "mark to market" its position on the option or forward contract and allocate any resulting loss in accordance with the Capitalization Proposal.

(5) The fifth Proposal (the "263(g) Proposal") would provide rules for determining when debt is "straddle-related," in which case interest on the debt would be subject to capitalization under Section 263(g).[3]

This report analyzes each of the Proposals and generally favors aspects of each, with important qualifications. In particular:

(1) We agree with the Stock-Exception Proposal to the extent that it provides that holding stock directly and entering into a short sale with respect to substantially identical stock is a straddle. We also see no particular reason to retain the "qualified covered call" rule, although, as discussed later in this report, we believe that similar (but possibly more restrictive) rules should be available with respect to stock and "covered call options," whether or not the call options in question are exchange-listed. If, however, the stock exception is to be repealed in its entirety, we believe it critically important that the legislative history provide preliminary guidance on Congress' view as to when a taxpayer's stock holdings and other positions constitute a straddle. We would suggest that Congress affirm the general principle that risk of loss with respect to stock is not "substantially diminished" for purposes of Section 1092 by any position that would not result in tolling of holding period for purposes of Section 246.[4]

---

[3] Unless otherwise specified, references to Sections are to sections of the Internal Revenue Code of 1986, as amended (the "Code") or the regulations promulgated thereunder.

[4] This principle would **not,** in isolation, answer the question of when stock and another position constitute a straddle. For instance, writing an out-of-the-money covered call on stock may not toll holding period for purposes of Section 246, but stock and such a covered call **should**, in our view, be treated as a straddle, because holding the stock diminishes the taxpayer's risk of loss on the call. As discussed below, however, we believe that the rules governing the holding period (continued...)

(2) We agree with the Debt-Straddle Proposal.

(3) We agree with the Capitalization Proposal to the extent that it proposes to replace the loss deferral rules of Section 1092 of the Code with a capitalization rule. We strongly disagree, however, with the proposed treatment of "unbalanced straddles" (*i.e.*, straddles one side of which is larger than the other, as in the example used above to illustrate the Capitalization Proposal).

(4) Provided that the Capitalization Proposal operates fairly, we agree with the Mark-to-Market Proposal.

(5) We agree with much of what is contemplated by the 263(g) Proposal, although certain of these results could be viewed as aspects of the Capitalization Proposal. For example, interest on debt that is itself part of a straddle, to the extent that the interest deduction mirrors an actual or projected increase in the value of an offsetting position that is not being taxed currently, could be treated as a loss subject to the basic straddle rule rather than Section 263(g).[5] We also suggest that for purposes of Section 263(g), interest capitalization is appropriate when debt is integrally related to a straddle that reduces risk of loss on personal property owned by the taxpayer. Examples of such situations include cases where creation of the straddle facilitates a borrowing (for instance, where stock and a collar are pledged to secure a loan) or where a borrowing facilitates or is inseparable from the reduction of a taxpayer's risk of loss on personal property (as is true, for instance, in the case of a publicly issued debt-forward unit with respect to stock owned by the taxpayer, where the debt operates as collateral for the public's performance under the forward contract).[6]

In addition to responding to the Proposals, we suggest other changes to or clarifications of the straddle rules. First, we suggest that the concept of "loss"

---

[4] (...continued)
of and interest capitalization with respect to a straddle position should not apply to any position as to which risk of loss is not "substantially diminished," such as stock subject to a covered call with a reasonably short term.

[5] As discussed in the following paragraph, we suggest expanding the concept of "loss" for purposes of Section 1092 beyond "losses" deductible under Section 165(a).

[6] On the other hand, for instance, we do not think it appropriate to capitalize interest on stock held in a margin account where the taxpayer writes a relatively short-term, out-of-the-money covered call with respect to the stock.

under the straddle rules be expanded to include an amount that represents an economic "loss," without regard to whether this amount is deductible under Section 165(a). Examples of such economic losses include certain payments with respect to contingent debt and certain payments under notional principal contracts. Second, we propose that the application of the straddle holding-period rules and the interest-capitalization rule of Section 263(g) to a particular position should depend on whether risk of loss with respect to that position is "substantially diminished." If, for instance, a taxpayer holds stock and writes a covered call that would not be viewed as reducing risk of loss with respect to the stock for purposes of Section 246, we do not believe that the taxpayer's holding period with respect to the stock should be affected.

While this report is framed as a response to the Proposals, which are legislative, we recognize the possibility that no tax legislation addressing the straddle rules will be enacted this year. It would be unfortunate, in our view, if failure to address the straddle rules legislatively resulted in no steps being taken to address the application of Sections 1092 and 263(g). We hope that in such a case this report will be used by Treasury in taking all steps it deems within its regulatory authority under those provisions of the Code. For instance, Treasury has an explicit mandate to address the question of unbalanced straddles, and should in our view do so promptly if no legislation is enacted that addresses that topic. Similarly, in the absence of legislative guidance regarding the application of Section 263(g), we would strongly urge Treasury to consider issuing regulatory guidance on this topic as well.

I. Overview

The straddle rules were an immediate and, by all accounts, effective response to a proliferation of certain abusive "shelter" transactions, primarily involving commodities. As originally enacted, the straddle rules had very limited application to transactions relating to stock. Today, however, after a slow-moving and complex set of legislative, regulatory and financial markets developments, many if not most of the unanswered questions that arise with respect to the straddle rules pertain to straddles involving stock and related positions.

We recognize that transactions hedging stock positions create the potential for tax avoidance, which must be prevented. Indeed, we believe that in certain cases the application of the straddle rules to equity-related positions should be expanded. We also believe, however, that the hedging of stock positions can serve legitimate and non-abusive economic goals, and to that extent should not be penalized. The straddle rules were originally designed as an anti-abuse regime targeting and penalizing participants in a relatively discrete set of non-economic tax shelters. Application of these rules to the many types of stock-related hedging transactions common in today's markets can entail significant uncertainties, which may at once discourage cautious taxpayers from entering into straddles out of concern that the rules will be applied in a punitive manner and encourage other taxpayers that enter into straddles to exploit uncertainty as a basis for taking aggressive positions.

One of the most important issues in applying the straddle rules in their current form is what we refer to as the "unbalanced straddle" problem. When Congress enacted the straddle rules in 1981, it was reacting to abusive transactions with little economic substance and a principal purpose of tax avoidance. However, even in that context, Congress recognized that the straddle rules were potentially overbroad in cases where one side of a straddle is larger than the other.[7] Accordingly, Congress directed the Secretary of the Treasury to promulgate regulations providing for a non-distortive application of the rules in such cases.[8] Eighteen years later, this directive has yet to be implemented. We believe that Congress can and should act to implement a legislative rule dealing even-handedly with unbalanced straddles, while delegating to Treasury the power to refine the rule by regulations. In the absence of legislation, we would strongly urge promulgation of regulations dealing with this issue, but we believe that if any straddle legislation is to be enacted, Congress should not defer to the regulatory process, which has thus far proved unproductive.

The preparation of this report began prior to the publication of the 2001 Revenue Proposals, in response to two straddle-related developments in 1999. The first development, which we viewed as decidedly positive, was the release of Private Letter Ruling 1999-25-044 (the "Ruling"), addressing the question of an unbalanced straddle. Briefly stated, the Ruling permitted a taxpayer that entered into an unbalanced straddle transaction with respect to a portion of the shares it held in a particular company to identify which portion of its "larger" stock position should be viewed as part of the straddle. We had hoped (and continue to hope, notwithstanding an about-face in the Capitalization Proposal) that the approach of the Ruling would be fleshed out and confirmed by legislation or promptly issued regulations, with appropriate guidance on such questions as which positions a taxpayer might be required or permitted to identify as an offsetting position.

The second significant straddle-related development in 1999 to which we intended to respond was a legislative proposal that included, in general terms,

---

[7] *See* S. REP. NO. 144, 97th Cong., 1st Sess. 147-48 (1981) [hereinafter *ERTA Senate Report*].

[8] Section 1092(c)(2)(B).

predecessors of the Stock-Exception Proposal and the 263(g) Proposal. We supported the 1999 proposals in large part, but thought that considerably more should be done legislatively to "modernize" the straddle rules, including (i) addressing the question of unbalanced straddles along the lines of the Ruling, as discussed above, (ii) providing clearer and somewhat more lenient rules for "risky" straddle positions (along lines somewhat similar to those that are now available to stock held as part of an economic straddle with a "qualified covered call"), (iii) articulating the principles that should govern application of Section 263(g), (iv) broadening the concept of "losses" subject to deferral under Section 1092, (v) providing guidance on what constitutes substantial diminution of risk, and (vi) addressing a number of technical issues, potential loopholes, etc.

The Proposals put much more on the table for discussion than the 1999 legislative proposal. In many respects, we view this as positive, although we are quite disappointed by the reversal of the identification regime contemplated by the Ruling. Other Proposals, which we generally support but had not previously considered suggesting, include the switch from a deferral regime to a capitalization regime and the Mark-to-Market Proposal. We support the concept of a capitalization regime because of its simplicity in typical cases, although it does prevent a taxpayer-friendly approach to "releasing" straddle losses when straddle-period gains disappear due to a subsequent decline in value of the "gain" leg of the straddle. We also see the Mark-to-Market Proposal as justifiable on the grounds that it more precisely matches economic gains and losses on straddle positions, although it does go beyond the original straddle concept of preventing the use of artificial losses to shelter income from non-straddle sources.

We have kept to the format we originally contemplated, which is first to set forth our thoughts on principles that should be followed in amending the straddle rules, then to comment on (and where appropriate, add to) the legislative proposals that are on the table. We think that this format remains useful because it is difficult to reach an informed judgment with regard to specific Proposals without a broader conceptual view as to how the straddle rules should apply to transactions occurring in the market today.

II. Summary

A. Current Law.

Part III of this report summarizes the straddle rules under current law. We explain that the rules were enacted in response to a limited number of well-recognized and clear abuses but are now routinely applicable to a much broader array of hedging and risk-reduction transactions than were originally contemplated. As a result, certain flaws and uncertainties in the operation of the rules may have discouraged some taxpayers from engaging in rational, non-abusive activity while encouraging other taxpayers to take aggressive positions based on the absence of clearly crafted rules.

B. The Loss-Deferral Rule.

In Part IV of this report, we discuss the loss-deferral rule. First, we propose that Congress enact legislation rationalizing the application of the straddle rules to unbalanced straddles. We discuss what we believe are the relevant approaches that Congress should decide among, and suggest that it enact statutory language that would be self-executing, subject to Treasury's ability to modify the statutory approach to the extent it determines necessary in order to carry out the purposes of the straddle rules. We then discuss the rule relating to unrecognized gain in offsetting positions and suggest a capitalization rule that we believe reflects the appropriate policy. Finally, we suggest expanding the definition of a "loss" for purposes of the straddle rules generally and the loss-deferral rule in particular.

C. Risk Reduction.

In Part V, we suggest that improvement is needed in the treatment of straddle positions as to which risk of loss is not substantially diminished. While the classic commodity straddles that prompted legislative action in 1981 involved "bilateral" risk reduction (*i.e,* risk of loss was substantially diminished on all positions in the straddle), the straddle rules apply even if substantial risk reduction is only "unilateral." For example, if a taxpayer holds stock and writes an out-of-the-money over-the-counter call option on that stock with a reasonably short term, he has eliminated his risk of loss with respect to the option but has probably not substantially diminished his risk of loss with respect to the stock. Nonetheless, the straddle rules apply to the stock in this example just as to any other straddle position. We suggest that generally it is not appropriate to subject such a "risky" straddle position to the straddle holding period rules. In addition, Part V discusses the "substantial diminution" standard.

D. The Interest-Capitalization Rule.

In Part VI, we consider the appropriate scope of Section 263(g), both under current law and as a matter of tax policy. We discuss a number of potential policy rationales relevant to determining the appropriate scope of Section 263(g), concluding among other things that Section 263(g) should be expanded to apply in situations involving any property that is part of a conversion transaction, whether or not that transaction is a straddle. In addition, we comment on when debt should be viewed as sufficiently "straddle-related" that interest should be capitalized into the basis of a risk-reduced position. Finally, we conclude that Section 263(g) should not apply to interest and expenses incurred or continued to purchase or carry a straddle position as to which risk of loss is not substantially diminished.

E. Analysis of the Administration's Proposals.

Part VII elaborates on our responses to the Proposals set out on pages 2-3, above.

F. Technical Changes.

In Part VIII, we discuss a number of proposed technical changes to the straddle rules. We discuss the relationship between Section 1233 and the straddle rules and suggest that consideration be given to whether Section 1233 should be repealed, with certain provisions added to Section 1092 in its place. We also propose (i) repeal of the qualified covered call exception and the identified straddle rules, (ii) modification of the definition of a "straddle position," (iii) modification of the holding-period loss rule to eliminate certain anomalous results, (iv) modification of the definition of "unrecognized gain" with respect to offsetting positions, (v) modification of the rules relating to related-party straddle transactions to prevent abuses and (vi) modification of the definition of "interest and carrying charges" for purposes of Section 263(g).

III. The Straddle Rules

A straddle is defined in Section 1092(c)(1) as offsetting positions[9] with respect to personal property.[10] Positions are offsetting if there is a substantial diminution of the risk of loss from holding any position by reason of holding one or more other positions.[11] For purposes of these rules, stock is generally not treated as personal property unless it is either (a) part of a straddle at least one of the offsetting positions of which is (i) an option with respect to such stock or substantially identical stock or securities[12] or (ii) under regulations, a position with respect to substantially similar or related property (other than stock)[13] or (b) stock

[9] A "position" means an interest, including a futures or forward contract or option. Section 1092(d)(2).

[10] "Personal property" is personal property of a type that is actively traded. Section 1092(d)(1).

[11] Section 1092(c)(2)(A).

[12] Section 1092(d)(3)(B)(i)(I).

[13] Section 1092(d)(3)(B)(i)(II).

of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.[14]

The straddle rules generally do not apply to hedging transactions as defined in Section 1256(e)[15] or to stock and "qualified covered call options."[16] The loss-deferral rule (described below) does not apply to "identified straddles."[17] Under regulations, special rules apply to "mixed straddles" at least one but not all of the positions of which are treated as "section 1256 contracts."

The primary consequences of the straddle rules are as follows: First, any loss with respect to a straddle position is taken into account in any taxable year only to the extent such loss is in excess of "the unrecognized gain (if any) with respect to 1 or more positions which were offsetting positions" with respect to such position (the "loss-deferral rule").[18] Second, the holding period of any position that is part of a straddle does not begin until the taxpayer no longer holds offsetting positions, unless such position was held for the long-term capital gain holding period prior to entering the straddle (the "holding-period rule").[19] Third,

---

[14] Section 1092(d)(3)(B)(ii).

[15] Section 1092(e). A hedging transaction is defined in Section 1256(e) as one entered into in the normal course of a trade or business primarily to reduce the risk of price changes or currency fluctuations with respect to property held or to be held, or of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, if the gain or loss on such transaction is treated as ordinary income or loss and if the transaction is clearly identified as such before the end of the day it is entered into.

[16] A qualified covered call option is defined in Section 1092(c)(4) as an option granted by the taxpayer to purchase stock held by the taxpayer but only if, generally, the option is traded on a registered national securities exchange or similar market approved by the Secretary, has a term of at least 30 days, is not "deep-in-the-money" (generally, its strike price is not lower than the highest available strike price lower than the stock price) and is not granted by an options dealer. If a taxpayer settles a qualified covered call option or sells the cover stock, in either case at a loss, and does not recognize the gain on the "offsetting" position in the year such loss is realized, the qualified covered call option and the stock will be treated as a straddle unless the taxpayer holds the remaining position unhedged for 30 days after the loss-triggering event. Also, if a taxpayer writes an in-the-money qualified covered call option, loss on the option will be long-term capital loss if gain on the stock would be long-term capital gain, Section 1092(f)(1), and the taxpayer's holding period for the stock is suspended during the term of the option (but is not destroyed), Section 1092(f)(2).

[17] Section 1092(a)(2)(B). The identified straddle rules are summarized in note 22, below.

[18] Section 1092(a)(1)(A).

[19] Treas. Reg. Section 1.1092(b)-2T(a). In addition, any loss on a straddle position is treated as long-term capital loss if on the day such loss position is entered into all gain or loss with

(continued...)

interest and carrying charges properly allocable to personal property that is part of a straddle, to the extent in excess of certain income generated by such property, must be capitalized rather than currently deducted (the "interest-capitalization rule") under Section 263(g).[20]

IV. The Loss-Deferral Rule

The basic loss-deferral rule provides that "[a]ny loss with respect to 1 or more positions shall be taken into account for any taxable year only to the extent that the amount of such loss exceeds the unrecognized gain (if any) with respect to 1 or more positions which were offsetting positions with respect to 1 or more positions from which the loss arose."[21] This rule presents two related problems: first, the application of the straddle rules where one side of a straddle offsets (or is offset by) only a portion of the other side (an "unbalanced straddle"); and second, the appropriate method for allocating a straddle loss to offsetting positions.

---

[19] (...continued)
respect to one or more positions in such straddle would be long-term capital gain or loss. *Id.* Section 1.1092(b)-2T(b). For further discussion of the holding-period loss rule, see Part VIII.D, below.

[20] In addition, regulations provide special "modified wash sale" rules for determining when losses from closing out straddle positions should be disallowed (and, in effect, carried over into the basis of successor positions) rather than deferred, as is usually the case for straddle losses. *Id.* Section 1.1092(b)-1T; *see* ERTA Senate Report, *supra* note 7, at 149 ("Thus, in most cases, the disallowance of losses under the section 1091 rule functions merely to defer the loss.").

[21] Section 1092(a)(1)(A).

A. Unbalanced Straddles.

Apart from the "identified straddle" provision[22] and the special rules for mixed straddles,[23] which apply only in limited circumstances, the straddle rules do not specify how to identify which gain positions are offsetting positions with respect to a position on which loss is realized.

For example, suppose taxpayer acquired 100 shares of XYZ stock at $10 per share. At a time when the stock is worth $100 per share, taxpayer sells a "covered call" option on 10 shares of XYZ stock,[24] with a strike price of $125 per share, for a premium of $50 ($5 per share subject to the option). Suppose that the stock price increases to $150 per share and the taxpayer cash-settles the call option at a $200 loss.[25] How many shares must taxpayer sell in order to recognize the $200 loss? Arguably, under Section 1092(a)(1)(A), even if taxpayer sells ninety-eight shares of XYZ stock, she cannot recognize any of the loss, because she will continue to have $280 of unrecognized gain in positions (the two shares of stock) that were "offsetting positions" with respect to the call option.

We believe that this result is uneconomic and without policy justification. In enacting the straddle rules in 1981, Congress expressed its awareness of the possibility that the rule could be applied in an uneconomic manner so as to defer

---

[22] Section 1092(a)(2)(A) provides that the loss-deferral rule does not apply to "identified straddles," defined in Section 1092(a)(2)(B) as any straddle (i) that is clearly identified before the close of the day on which acquired (or earlier, if the Secretary so prescribes), (ii) all of the original positions of which (as so identified) are acquired on the same day (provided that all or none of such positions are disposed of on any day during the taxable year) and (iii) that is not part of a larger straddle. Section 1092(c)(2)(C) provides that any position that is not part of an identified straddle shall not be treated as offsetting with respect to any part of an identified straddle. Many practitioners are concerned that the negative implication of the identified straddle rule is that, absent compliance with these rules, a taxpayer holding an unbalanced straddle will not be permitted to identify a portion of a gain position as offsetting a smaller loss position (*i.e.*, a loss position that economically offsets only a portion of the gain position) for purposes of determining when there is no remaining unrecognized gain in offsetting positions. ***But see*** Priv. Ltr. Rul. 1999-25-044 (Feb. 3, 1999), discussed below.

[23] Treas. Reg. Section 1.1092(b)-3T, 1.1092(b)-4T.

[24] Assume that the option is not exchange-traded and therefore is not a "qualified covered call option."

[25] Taxpayer's loss is determined as follows: $150 stock price - $125 strike price = $25 per share * 10 shares = $250 owed to counterparty, minus $50 premium received.

straddle losses.[26] Thus, Section 1092(c)(2)(B) provides that "[i]f 1 or more positions offset only a portion of 1 or more other positions, the Secretary shall by regulations prescribe the method for determining the portion of such other positions which is to be taken into account for purposes of this section." Treasury has not promulgated such regulations in the ensuing 18 years.[27] As we have previously stated, "[t]he absence of any guidance on this question under section 1092(c)(2)(B) means that taxpayers often are unable to enter into economic hedges of their stock positions without risking potentially severe adverse tax consequences."[28] We are strongly of the view that, in the absence of such regulations, it is appropriate for Congress to modify Section 1092(c)(2)(B) by enacting a regime for applying the straddle rules to unbalanced straddles that fairly and clearly reflects the economics of a straddle.

In crafting the appropriate approach to such a regime, it is helpful to review the purposes of the straddle rules. In summary, the straddle rules were first enacted to correct perceived abuses relating to the generation of uneconomic deductions and the "aging" of capital assets without risk.[29] The essence of these transactions was that a taxpayer would enter into offsetting positions (typically with respect to commodities) that all but eliminated any risk of economic loss with respect to each other. For example, a taxpayer might enter into a contract to buy silver in one future month and a contract to sell silver in another (proximate)

---

[26] *See, e.g.*, ERTA Senate Report, *supra* note 7, at 147-48 ("If there is more than one position with unrealized gain which was acquired prior to the loss disposition, which offsets the loss position and which does not belong to an identified straddle, the bill authorizes the Secretary of the Treasury to prescribe regulations for allocating the loss among the unrealized gain in such positions and for allocating unrealized gain among loss positions. The committee intends that allocation of unrealized gain positions to unrealized losses be done in a consistent manner that does not distort income. Regulations issued under this bill should provide that one dollar of unrealized appreciation at the end of any year defer at most only one dollar of realized loss."); Staff, Joint Comm. on Tax'n, *General Explanation of the Economic Recovery Tax Act of 1981*, 284 (1981) ("The Treasury will have to prescribe regulations to deal with the situation in which the realized loss on the loss legs of a straddle exceeds the unrealized gain on the gain legs. These regulations will provide rules for allocating the losses among the unrealized gain positions and determining which of the losses will be deductible and which will be deferred.").

[27] However, as mentioned on page 5, above, the Internal Revenue Service has recently released a Private Letter Ruling addressing the appropriate procedures for identifying what portion of a larger position is a position in a straddle.

[28] Tax Section, New York State Bar Ass'n, *Report on Proposed Regulation Section 1.1092(d)-2,* at 9 (Oct. 6, 1995) [hereinafter *1995 Report*].

[29] For an excellent explanation of the perceived abuses that prompted the enactment of the straddle rules, see Staff, Joint Comm. on Tax'n, *Background on Commodity Tax Straddles and Explanation of S. 626* (June 11, 1981).

future month.[30] The taxpayer would then "cherry-pick" the position that was trading at a loss at the end of one year by disposing of such position, re-entering a similar transaction to hedge the remaining position until it could be disposed of in the next year, at long-term capital gain rates. Thus, the taxpayer would separate a loss from its economically "paired" (*i.e.*, straddle-period) gain and use it to shelter income in an earlier year, deferring recognition of the gain until a later year when it was taxed at the lower long-term rate.

Conceptually, the loss-deferral rule combats this abuse by "matching" a straddle loss to associated straddle-period gain – *i.e.*, the rule defers the loss until the taxpayer no longer holds the offsetting position with the corresponding unrecognized gain.[31] Similarly, with respect to unbalanced straddles, we think that matching the straddle loss as closely as possible with associated straddle-period gain brings the tax accounting of financial hedging transactions into line with our realization regime as reflected in Section 1012.[32] Recognizing straddle losses before the recognition of an appropriate amount of straddle-period gains constitutes inappropriate "cherry-picking." On the other hand, recognizing straddle-period gains before the recognition of associated straddle losses is inconsistent with our realization-based regime, as illustrated in the following examples.

Consider a regime in which taxpayers must defer straddle losses until they have eliminated unrecognized gain in all possible offsetting positions (or, alternatively, in which straddle losses must be capitalized into the basis of the last positions sold). Now suppose a taxpayer has two shares of stock worth $100, one with a basis of $80 and the other with a basis of $50. The taxpayer enters into a "costless, 100-120" cash-settlement collar with respect to one share (*i.e.*, the taxpayer agrees to deliver cash equal to the excess, if any, of the price of the share over $120 at maturity and has the right to receive cash equal to the excess, if any, of $100 over the price of the stock at maturity). Suppose the stock is worth $250 at maturity, and the taxpayer therefore pays the counterparty $130. Assume that the stock price thereafter stays at $250. If the taxpayer is required to sell both shares before he can recognize the loss, he would sell his $80-basis share for $250

---

[30] *See* Rev. Rul. 77-185, 1977-1 C.B. 48.

[31] Generally, this would occur if the taxpayer sold the offsetting position or the offsetting position depreciated in value so that the amount of unrecognized gain was less than the amount of the deferred loss. For a more detailed discussion of this issue, see Part VIII.E, below.

[32] Of course, administrability and fairness are countervailing considerations that may militate against a regime that imposes "perfect" matching.

and recognize \$170 of gain (\$150 of which is straddle-period gain),[33] after which he could sell his second share for \$250 and recognize \$70 of "net" gain (*i.e.*, \$200 gain minus \$130 straddle loss). If instead the taxpayer had physically settled the collar by delivering his \$80-basis share in exchange for the \$120 "upper strike" price, under current law he would recognize \$40 of net gain. The tax consequences of physical settlement by delivery of properly identified shares held throughout the term of the straddle are in no sense abusive; indeed, they reflect the appropriate result under our realization-based system. We believe that the straddle rules should operate consistently with the results of physical settlement of the contract, which can only be achieved by permitting an identification regime.

Under the Capitalization Proposal, taxpayers must capitalize straddle losses into the basis of their lowest-basis potentially offsetting positions first until all such positions have an equal basis and must then capitalize the remaining straddle losses *pro rata* into all possible offsetting positions. Consider the above example under this regime. The taxpayer would capitalize \$30 of the loss into his lower-basis share and the remaining \$100 into each share equally, so that each share would have a basis of \$130.[34] Thus, when he sells one share for \$250 he will recognize \$120 of gain. As with the first example, this regime goes well beyond matching straddle-period gains and losses, the intent of the straddle rules. As noted above, if the taxpayer had physically settled the collar by delivering his highest-basis share, he would have recognized only \$40 of gain. We see no policy basis for treating taxpayers less favorably under the straddle rules than they are treated under our system of realization.[35]

The regulatory authorization to deal with unbalanced straddles provides that "the Secretary shall by regulations prescribe the method for determining the portion of such other positions which is to be taken into account . . . ." Returning to our covered call example from page 11 above, this language suggests that the

[33] Note that if recognition of gain on the sale of the first share were permitted to "free up" the loss, the tax law would in effect treat the taxpayer as having sold the first share for \$120, which is exactly what he did as an economic matter.

[34] This observation highlights a potential flaw in the logic of the Capitalization Proposal – if a loss position is viewed as offsetting all of a taxpayer's potentially "offsetting" positions, as the Proposal suggests, then one might be forced to conclude that the loss position did not substantially diminish the taxpayer's risk of loss with respect to any such position and thus did not create a straddle at all. For example, if a taxpayer holds 1,000 shares of stock and purchases a put on two shares which expires unexercised, and if the "offsetting position" is all 1,000 shares of the stock, it would be difficult to argue that the put option substantially diminished the taxpayer's risk of loss with respect to the offsetting position.

[35] However, it may be viewed as inappropriate to permit taxpayers to identify shares with a basis in excess of their fair market value. *See infra* page 16.

Secretary should determine how many XYZ shares are offsetting with respect to the call option. In our example, we think it clear that ten shares should be viewed as the offsetting straddle position. However, determining that ten shares should be viewed as "offsetting" with respect to the option does not resolve the issue of determining *which* ten shares should be treated as offsetting with respect thereto. We would propose an approach that permits taxpayers to identify, prior to or simultaneously with entering into a straddle, which portion of a larger position will be treated as the straddle position. This is the approach taken by the Internal Revenue Service recently in the Ruling. We consider this a very reasonable approach to the unbalanced straddle problem, and we believe that it is appropriate for Congress to enact such a regime in order finally to provide much-needed certainty in this area.

There are a number of potential issues associated with the identification regime, which could be addressed by statute or by regulation. For instance, it would be helpful to provide a default rule applicable in the event that a taxpayer does not, or does not properly, identify the offsetting positions with respect to a loss position in an unbalanced straddle. A taxpayer who fails to properly identify offsetting positions might be treated as having identified as part of the straddle the lowest-basis offsetting positions that were held when the straddle was entered into,[36] his longest-held offsetting positions[37] or his longest-held positions that were acquired within the one-year period ending on the date of the straddle.[38] Any of these rules would be acceptable, in our view; the most important thing is that the rule be clear and simple. If a taxpayer physically settled a loss position with property other than that identified upon entry into the straddle, she should be subject to rules similar to the Mark-to-Market Proposal (whether or not that Proposal is adopted as a general matter) – *i.e.,* she should be treated as having sold

[36] Although this default rule is arguably punitive, it generally should encourage identification by taxpayers at the time of entering into a straddle, and preclude attempts to "cherry-pick" the best result at the time one or both legs of the straddle are closed out.

[37] This default rule would be most consistent with the "FIFO" default rule for sales of stock. *See* Treas. Reg. Section 1.1012-1(c)(1).

[38] *Cf.* Section 1233(b)(2) (applying such an ordering rule for purposes of the rule that property subject to a short sale and held for not more than one year at the time of the short sale, or acquired after the short sale, is treated as acquired not earlier than the date of the short sale). Note that the result of the application of Section 1233(b) is the elimination of holding period of stock held for less than the long-term capital gain holding period at the time of entry into a short sale.

the delivered stock for its fair value and as having realized a straddle loss that is capitalized into the basis of the identified property.[39]

Difficult questions arise regarding the "ground rules" of the identification regime. For example, it might be viewed as inappropriate to permit a taxpayer to identify an item of property with a basis in excess of its value as a straddle position in any case where the taxpayer holds other potential straddle positions with a basis less than or equal to fair value. The argument for this view is that taxpayers should not be permitted to use pre-straddle-period losses to offset straddle-period gains. Indeed, one could argue that taxpayers should identify their lowest-basis property. However, we believe that the latter is an unduly harsh rule that, as illustrated in the examples described on pages 13-14, above, is inconsistent with our realization-based system. In our view, the purposes of the straddle regime are adequately served by requiring the taxpayer to identify, at inception of the straddle, property with a basis less than or equal to its fair market value (and, to the extent such an identification is not possible because the taxpayer's holdings consist in whole or in part of units of property, such as shares, with a basis in excess of fair market value, the lowest-basis among such units of property).[40]

In addition, Treasury should be given authority analogous to the "clear reflection of income" authority under Section 446(b) to determine whether a taxpayer's identification of a straddle position or positions is reasonable. As an example of a potentially unreasonable identification, Treasury might address the

---

[39] Treasury should be given regulatory authority to address the tax consequences if a taxpayer sells or disposes of identified straddle property before the offsetting loss position is disposed of. One solution would be to require that the positions be marked to market on such date. Any resulting loss would be capitalized into the basis of the identified straddle property (reducing the amount of gain recognized), and thereafter the straddle rules (including any default identification rule, assuming the taxpayer held other potentially offsetting positions and did not properly identify a "replacement" straddle position) would apply to the loss position and the taxpayer's remaining offsetting property as if the loss position were entered into on the date of such sale. This approach could apply where the taxpayer disposes of some but not all of his identified straddle property; in such circumstances, any remaining originally identified straddle property should be deemed to be "re-identified" for purposes of the operation of the rule.

[40] We do not believe that such a system should result in any loss on the offsetting leg exceeding the (unrealized) straddle-period gain on the identified property. Any such outcome would suggest that the identification was too "narrow." Assume, for instance, that a taxpayer identified 100 shares (out of a larger holding of, say, 1,000 shares) with a basis equal to fair market value as one leg of a straddle with a derivative instrument. If the shares increased in value $1 per share during the term of the straddle, for a total of $100 of unrealized gain, while the derivative instrument was settled at a $200 loss, logic would indicate that the derivative instrument probably substantially reduced the risk of loss on 200 rather than 100 shares. In any event, such a situation could be adequately addressed by the proposal set out in the next paragraph.

following: Suppose at a time when XYZ stock is worth $100 per share, a taxpayer purchases 100 shares of XYZ stock and an 18-month call option on 100 shares of XYZ stock with a strike price of $120. If the taxpayer also writes an 18-month call option on 100 shares of XYZ stock with a strike price of $125, it would not seem reasonable to identify the taxpayer's XYZ stock as the offsetting position with respect to the written call, particularly where (as we are proposing) the taxpayer could thereby accrue holding period on both the stock (because it is a risk position, as discussed in Part V.A, below) and the purchased option (because the purchased option has not been identified and thus is not a straddle position).

Consideration should also be given to whether special rules should be promulgated dealing with economic straddles one leg of which consists of an employee stock option, or non-vested compensatory shares as to which no election has been made under Section 83(b). For example, suppose that a taxpayer who owns nonqualified employee stock options on 100 shares that are "in the money" (*e.g.*, strike price of $10, fair market value of stock is $40) and 100 appreciated shares of the employer's stock (*e.g.*, shares that have already vested or been subject to a Section 83(b) election) enters into a collar transaction with respect to 100 shares of the stock.[41] If the taxpayer is permitted to identify the options as the offsetting straddle position with respect to the collar, a number of issues will arise. For example, should the employer's compensation deduction[42] be a function of the taxpayer's ultimate inclusion, taking account of basis adjustments resulting from the collar? Will such adjustments affect the computation of the taxpayer's "wages" for purposes of the assessment of payroll taxes under Section 3101? Perhaps most fundamentally, should an amount that in most cases would be treated as a capital loss on a stand-alone basis be permitted to increase the basis of the taxpayer's employee stock options and thereby reduce the taxpayer's ordinary compensation income without limitation?

As another example of a technical issue that might be addressed by regulations, suppose a taxpayer that holds 100 shares of ABC stock with a basis of $0 and a value of $100 issues a $100 debt (or "deposit")-forward instrument (of the type commonly referred to as having "DECS" economics) that, in effect, eliminates the taxpayer's risk of loss on 100 shares of ABC stock below $100 and eliminates the taxpayer's opportunity for gain on 80 shares of ABC stock above $125. Should the taxpayer be permitted to identify 100 shares with the

---

[41] We assume that the terms of the collar are such that it does not constitute a constructive sale of the stock or (assuming this could be the case) the option. We note in passing that consideration should be given to whether the constructive sale rules should ever apply to employee stock options and, if so, whether the "constructively sold" option should thereafter be treated as outside the scope of Section 83.

[42] *See* Section 83(h).

"embedded" put option and only 80 of those shares with the "embedded" call option? This issue is most relevant if the Mark-to-Market Proposal is adopted. Suppose, for example, that the ABC stock is worth $175 when the taxpayer physically settles the contract by delivering 80 shares. Assuming that the Mark-to-Market Proposal is enacted and our identification proposal is adopted, the issue is whether the $4,000 loss on settlement of the contract should be allocated *pro rata* to all 100 shares owned by the taxpayer or only to the 80 shares that the taxpayer delivers. The question, as we see it, involves a trade-off between precision and complexity.[43] On balance, we believe that an approach that involves bifurcating a single indivisible financial instrument into separate instruments is likely to lead to an undue level of complexity.[44]

B. Allocating Straddle Losses.

Once one identifies the "offsetting position" with respect to a straddle position as to which loss is realized, it is necessary to determine the appropriate treatment of the realized straddle loss. The statute currently requires that unrecognized gain in "offsetting positions" be recognized or eliminated before a straddle loss is recognized. Thus, although the Treasury has the regulatory authority to determine what should be considered an "offsetting position," it is somewhat less clear whether current law would permit the Treasury to promulgate regulations permitting the recognition of a straddle loss except to the extent it

---

[43] As discussed in note 97, below, the Mark-to-Market Proposal itself adds complexity to further the goal of better matching straddle-period gains and losses. Assuming that the Proposal and its attendant complexity are adopted, the issue is how precise to make the overall system.

[44] The issue of bifurcation is also presented in determining how the straddle rules apply to a "collar," although in that case we view bifurcation as adding complexity with no benefit in terms of precision. Suppose a taxpayer owns stock worth $100 and enters into a 3-year "90-120 costless collar" in which he agrees in a single indivisible instrument with one counterparty to sell the stock after three years for $120 if it is then worth more than $120 or to sell the stock after three years for $90 if the stock is then worth less than $90. The taxpayer might be viewed as having entered into two separate transactions, a purchased put option (for which he might be deemed to have paid a premium of, say, $15) and a written call option (for which he might be deemed to have received a premium of $15). Each of these "options" would form a straddle with the stock, so that if the stock is worth between $90 and $120 after three years, the taxpayer would be required to include in income $15 of short-term capital gain on the "lapse" of the written call option and to capitalize a $15 straddle loss on the "lapse" of the purchased put option. Bifurcation clearly adds complexity to the tax treatment of such transactions, although we do not believe that it more precisely reflects the taxpayer's income than treating the collar as a single indivisible financial instrument with respect to which no upfront consideration is paid by either party and no income or loss is realized at maturity if the collar expires with no payment due by either party.

exceeds the unrecognized gain with respect to the entire "offsetting position."[45] We do not believe that this is the appropriate result, however, and we would encourage Congress to amend the statute, either to address the issue directly or to confirm Treasury's authority to do so. In the absence of legislation, we also would encourage Treasury to consider exercising its regulatory authority to address this topic. Below we discuss our proposal to address the appropriate allocation of straddle losses, as well as a number of alternative regimes.

The Capitalization Proposal would require capitalization of straddle losses into the basis of offsetting positions. Although, as discussed in Parts IV.A, above and VII.C, below, we strongly disagree with the Administration's proposed treatment of unbalanced straddles, we otherwise support the proposal to capitalize straddle losses. While capitalization and deferral regimes can be used to similar effect, we support a capitalization rather than a deferral regime because capitalization obviates a host of potentially difficult questions relating to the treatment of pre-straddle period gains and losses.[46] Also, a capitalization regime eliminates the need to analyze whether there is "unrecognized gain" in offsetting positions; once the appropriate offsetting position is identified and an appropriate mechanic for capitalization is selected, whether there is unrecognized gain in the offsetting positions is irrelevant. Moreover, capitalization tends to be more common in the tax law, and is easier to understand and administer, than a deferral regime that includes subsequent "release" of deferred losses to the extent the gain positions decline in value.[47]

---

[45] *See U.S. Securities Markets Coalition, Written Statement of the U.S. Securities Markets Coalition Submitted to the Committee on Ways and Means, U.S. House of Representatives, reprinted in* 1999 Tax Notes Today 140-36, ¶¶ 23-25 (July 22, 1999) [hereinafter *SMC*] (proposing that the statute be amended to provide for proportionate release of deferred losses as portions of the gain on "offsetting position" are recognized).

[46] As an alternative to capitalization, taxpayers could be required to "mark" the offsetting straddle positions to market, not for current tax-accounting purposes but solely for purposes of computing straddle-period gains and losses, on the dates on which a straddle is entered into and terminated. The taxpayer could then allocate straddle losses to identified offsetting positions that were held during the entire term of the straddle in proportion to the straddle-period gains reflected in those identified offsetting positions at the time the deferred loss is realized.

[47] One disadvantage to taxpayers of a capitalization regime is that a taxpayer will not receive the benefit of a straddle loss as a result merely of the reduction in unrealized gain with respect to the offsetting straddle position, but must instead dispose of that position in order to realize the benefit of the loss (in the form of a reduction of gain, or an increased loss, on the position).

Another disadvantage is that a capitalization regime would likely create substantial complexity in the context of "mixed straddles," *see* Treas. Reg. Sections 1.1092(b)-3T, -4T, including potential character mismatching issues and a "one-way ratchet" concern similar to that

(continued...)

We would propose that taxpayers be required to capitalize a loss into the basis of all positions that are properly identified at the time of entering into the straddle as offsetting with respect to a straddle position terminated or disposed of at a loss. We think that, once an appropriate offsetting position has been identified, allocating the loss to each item of identified property in proportion to the straddle-period gains with respect to such item is most consistent with the policy of the straddle rules, as discussed throughout this Report.[48] As discussed in Part IV.A, above, consideration should be given to whether it is necessary to provide that positions with a tax basis in excess of fair market value cannot be identified as straddle positions if the taxpayer holds other positions that do not have such a "built-in loss."[49]

Thus, in the example described on page 11, the offsetting position would consist of ten shares of stock identified by the taxpayer. The $200 loss would be capitalized into the basis of each of those ten shares *pro rata,* that is, $20 per share. Accordingly, if taxpayer thereafter sells one share, the gain that would otherwise be recognized on that sale will be reduced by $20.

One alternative method of capitalizing straddle losses to offsetting positions would be to capitalize straddle losses into the basis of the first shares sold, which is the equivalent of a loss-deferral rule that applies only after all realized gains and losses from offsetting straddle positions are netted against each other for the taxable year.[50] Thus, in the above example, if the taxpayer sold one share of stock for $160, she would have a $160 basis in that share ($10 original

[47] (...continued)
described in Part IV.C, below.

[48] The approach of the Capitalization Proposal (*i.e.*, equalizing basis first and then capitalizing the loss *pro rata*) seems more focused on eliminating unrealized pre-straddle-period gains than on matching straddle-period gains and losses. In addition, this approach can produce different results depending on the form of the transaction. For instance, writing ten separate call options with respect to ten shares with different bases would result in different capitalization (assuming the form was respected) than entering into a single call option with respect to the ten shares.

[49] Consideration should also be given to whether any existing provisions of the straddle rules may be obviated by the adoption of a capitalization regime for straddle losses. For example, the straddle wash-sale rule, *see supra* note 20, and the concept of a "successor position" as defined in Treas. Reg. Section 1.1092(b)-5T(n) and used in Treas. Reg. Section 1.1092(b)-1T(a)(2), would seem to have little or no continuing relevance if a capitalization regime is adopted. Moreover, the holding-period loss rule of Treas. Reg. Section 1.1092(b)-2T(b), discussed in more detail in note 19 above and Part VIII.D, below, would appear unnecessary, as discussed in notes 61 and 63.

[50] *See* ANDREA S. KRAMER, FINANCIAL PRODUCTS: TAXATION, REGULATION, AND DESIGN 284-87 (Rev. Ed. 1997 Cum. Supp.).

basis plus $150 of capitalized loss), recognizing no gain. This approach seems unduly generous in that it has the effect of permitting taxpayers to use straddle losses to shelter pre-straddle appreciation in offsetting positions.[51]

A modified (and somewhat more appealing) form of the "first-dollar" approach would capitalize loss into the first offsetting positions sold, but only to the extent of the straddle-period gain built in to such position. In the above example, because the taxpayer would have a $50 straddle-period gain if she sold a share of stock for $160 ($150 stock price at termination of straddle minus $100 stock price at inception of straddle), $50 of her loss would be capitalized into the basis of that share.

C. *The Definition of "Loss."*

The straddle rules operate to defer a straddle "loss" to the extent of unrecognized gains in offsetting positions. The Code does not define "loss" for this purpose, although regulations under Section 1092(b) provide generally that a "loss" means a loss otherwise allowable under Section 165(a).[52] We believe that it is appropriate to specify in the Code and/or regulations that a straddle "loss" includes any deductible amount determined by reference to the value of personal property if the taxpayer's position with respect to such personal property is a straddle position.

For example, under current law, a "positive adjustment" with respect to contingent payment debt (which is otherwise treated as interest) is explicitly treated as a loss potentially subject to the straddle rules. *See* Treas. Reg. Section 1.1275-4(b)(9)(vi). Positive adjustments are commonly caused by an increase in the value of underlying property in excess of the "projected" payment. Thus, if the taxpayer holds such underlying property, we think it clear that this is an appropriate result from a policy perspective. Similarly, we believe that a taxpayer that holds personal property such as stock and enters into a notional principal contract (a "swap") such that the two positions constitute a straddle should be subject to the straddle rules with respect to payments made under the swap, whether such payments are treated as ordinary or capital.

Broadening the range of items treated as straddle losses raises a number of issues as to which guidance would be helpful, however. For example, suppose a taxpayer who owns $100 worth of ABC stock (the "Stock"), with a basis equal to

---

[51] In that sense, its operation would be similar to that of the investment interest rules of Section 163(d), which permit investment interest to shelter any investment income (including appreciation arising in prior periods) but not other forms of income.

[52] Treas. Reg. Section 1.1092(b)-5T(d).

its fair market value, enters into a 3-year "short" swap with respect to the Stock. The swap provides that at the end of each 1-year period, the taxpayer will receive from the counterparty a percentage of $100 (say, 6%) plus the decrease in the value of the Stock during the period and will pay to the counterparty the amount of any dividends received on the Stock during the period plus any appreciation in the value of the Stock during the period (such payments to be aggregated and netted with respect to each period).

Initially, suppose the Stock increases in value by $6 in each period and no dividends are paid on the Stock, so that no payment is made by either party during the entire term of the swap. We see no reason to require the taxpayer to bifurcate the transaction, recognizing $6 of income in each period while capitalizing the $6 of "loss" in each period into the basis of the Stock. This is because as an economic matter the taxpayer has recognized neither gain nor loss as a result of the swap – the economics of the swap are equivalent to the cash settlement of a fixed-price forward contract at a time when the stock is worth the forward price and thus no cash changes hands. We believe that these economically indistinguishable transactions should be taxed similarly.

To vary the facts in order to illustrate a second issue, suppose that the value of the Stock does not change during the first period, increases by $17 in the second period and increases by $3 in the third period. Again, assume no dividends are paid on the Stock. Thus, the taxpayer receives $6 in the first period, pays $11 in the second period and receives $3 in the third period. Obviously, the taxpayer will account for $6 of income in the first period. As to the second period, requiring the taxpayer to capitalize the $11 paid to the counterparty results in a "one-way ratchet" that is uneconomically adverse to the taxpayer. A more even-handed (albeit more complex) system would permit a deduction of $6 in the second period, as an "offset" to the taxpayer's $6 inclusion in the first period. The remaining $5 would be deferred and carried forward to future periods. Thus, in the third period, the taxpayer would include $3 of income and deduct $3 of her carried forward loss, capitalizing the remaining $2 of loss into the basis of the Stock.

To summarize the system we are describing, net periodic swap "losses" (whether ordinary or capital) would be recognized to the extent of prior income inclusions, with any excess loss deferred and carried forward to future periods. Any net loss (including loss carryforwards) at the maturity of the swap would be capitalized into the basis of the offsetting property.[53]

---

[53] Obviously, such a system is too complex to codify. Assuming Congress favored such a system (or some variation thereof), it would be helpful if the legislative history so indicated, with a (continued...)

A second issue raised, in the context of contingent debt that constitutes one leg of a straddle, is whether "phantom" interest deductions should be treated as "losses" subject to the capitalization regime. For example, suppose a taxpayer issues a three-year "optionally exchangeable" debt security that is linked to the value of stock held by the taxpayer – i.e., the instrument pays a current coupon of 3% and will pay at maturity its principal amount plus the amount of any increase in the value of the stock. The contingent payment debt instrument rules of Treasury Regulations Section 1.1275-4 (the "CPDI rules") will generally require a determination of the taxpayer's "comparable yield" on similar noncontingent debt – for example, 8%, and a projected payment at maturity of the debt instrument. To the extent that the taxpayer's interest deduction is determined by reference to a projected payment that will only be paid if the value of the stock owned by the taxpayer has increased by that amount (*i.e.* to the extent of the "phantom" component of such deduction), should such interest be viewed as a "loss" with respect to a straddle position, and thus capitalized without regard to the application of Section 263(g)? Because either such interest will never be paid (for example, because the stock price does not rise during the term of the debt) or, if it is paid, it will be offset by an increase in the value of the stock, an argument can be made that the risk of this economic expense has been eliminated by holding the stock.

A plausible counterargument is that these "phantom" accruals are a direct and intended consequence of the CPDI rules and that the treatment of such amounts as a nondeductible straddle "loss" is tantamount to repealing the CPDI rules as they apply to the issuers of "covered" contingent payment debt securities. Moreover, the premise of the CPDI rules is that these deductions are appropriate in that they reflect not an actual increase in the value of the underlying property but the issuer's "comparable yield" and thus its "true" cost of borrowing.[54] Under this line of reasoning, the issuer's ability to deduct original issue discount under

---

[53] (...continued)
direction that the topic be addressed promptly in regulations. Note that a similar "one-way ratchet" concern applies in the context of periodic contingent payments on debt instruments. In such a case, as in the case of contingent payment swaps, arguably the "loss" resulting from a positive adjustment in any period should be deductible currently to the extent of any prior inclusions resulting from negative adjustments, and then carried forward. See notes 47 and 94 for a discussion of this "one-way ratchet" concern as it relates to "mixed straddles," some but not all of the positions of which are marked to market under Section 1256.

[54] Again, as discussed above, any positive adjustments that result when a contingent payment is larger than its "projected" amount may be treated as a straddle loss under the current CPDI rules, Treas. Reg. Section 1.1275-4(b)(9)(vi).

the CPDI rules should depend upon whether Section 263(g) applies,[55] and only positive adjustments with respect to the debt instrument should be treated as straddle "losses." This approach would minimize the discontinuity, from the issuer's perspective, between the tax treatment of a contingent payment debt instrument and that of separately issued debt and a written call option.

V. Diminution of Risk of Loss

A. Bilateral Risk Reduction.

One fundamental aspect of the straddle rules that is worth questioning is that they apply equally to all straddle positions. Bilateral risk reduction is not required in order for two or more positions to constitute a straddle. Thus, under current law, when a position (the "hedging position") reduces the risk of loss with respect to another position (the "hedged position"), and both are positions with respect to actively traded personal property, both the hedging position and the hedged position are subject to the holding-period elimination rule of Treasury Regulations Section 1.1092(b)-2T(a) and also potentially subject to the interest-capitalization rule of Section 263(g).[56] For the reasons stated in this section, we believe that application of these rules to the hedging position is not appropriate if the risk of loss on this position is not substantially diminished.

The focus of Congress' attack in the original straddle rules was generally "classic" straddle transactions in which a taxpayer entered into a "spread" or a "butterfly" in which substantially all of his risk from holding each position was reduced by holding the other(s). In this light, it seems natural to apply the loss-deferral, holding-period and interest-capitalization rules to all straddle positions. In fact, however, a straddle position may be held without substantial diminution of risk of loss on that position. The most obvious example is stock held subject to an out-of-the-money written call option. Clearly, the stock reduces (eliminates) the taxpayer's economic risk of loss on the written option. It is quite possible, however, that the call option does not substantially diminish the taxpayer's economic risk of loss on the stock.[57] In other words, notwithstanding the status of

---

[55] As discussed in Part VI.B, we believe the application of Section 263(g) should depend upon whether the issuer has "substantially diminished" its risk of loss with respect to the stock by issuing the debt instrument, which might not be the case under the facts as stated.

[56] We do not use the term "hedging" here in the technical sense contemplated by Treasury Regulations Sections 1.1221-2 and 1.446-4.

[57] Although the taxpayer has received a premium for writing the option, arguably reducing his risk that the stock price may decline by the amount of the premium, we believe that the premium received with respect to an out-of-the-money call option with a reasonably short term
(continued...)

the stock as a "position" in a "straddle," the taxpayer may be exposed to a large portion of the "downside" economics of the stock. In such a case, we believe that interest and carrying charges allocable to the stock should not be capitalized into its basis, because the straddle rules should not concern themselves with the debt-financing of positions held subject to a substantial risk of loss. In addition, the holding period of a non-risk-reduced position should not be tolled (much less eliminated) during the term of the straddle.[58]

Thus, to implement the proposal set forth in this section, we recommend that Congress enact a new subsection of Section 1092(g) providing that if a straddle position is a "risk position" then such position will not be subject to the holding-period rule or the interest-capitalization rule. For this purpose, a "risk position" would be defined as any straddle position the risk of loss with respect to which is not substantially diminished by virtue of any one or more other positions.[59]

In addition, as described below in Part VIII.B, we propose to repeal the qualified covered call option exception. Thus, although the proposal described in this Part V.A has the effect of exempting risk positions from the operation of certain of the straddle rules, we believe that the overall effect of the proposal would be to increase the coverage of the straddle rules, which currently (and, we believe, inappropriately) permit the recognition of losses with respect to qualified covered call options prior to the recognition of offsetting straddle-period gains in the cover stock.

If the limitation on the holding-period rule is adopted, two additional provisions should be considered in order to prevent arguably inappropriate results.[60] The rationale for both of these rules is that a taxpayer who writes a

---

[57] (...continued)
generally should not be viewed as "substantially diminishing" the risk of loss on the stock. *Cf.* S. Rep. No. 313, 99th Cong., 2d Sess. 906 (1986) ("In addition, the Committee wishes to clarify that the 1984 Act did not change the principle that the dividend received deduction is not disallowed by reason of an out-of-the money call option that affords the corporation no protection against loss in the event the stock declines in value.") (citing Rev. Rul. 80-238, 1980-2 C.B. 96). For a general discussion of the "substantial diminution" standard, see Part V.B, below.

[58] For a discussion of certain circumstances in which we believe that risk-reduced positions should be exempt from the holding period rule, see Part VIII.A, below.

[59] Consideration should be given to whether a purchased put option should generally be treated as a risk-reduced position for this purpose.

[60] A possible rationale for not adopting the proposals set out in the text that follows is that the scope of the potential problem is sufficiently limited that the complexity of the proposals is
(continued...)

covered call option has effectively sold some of his potential for appreciation in exchange for the call premium. For example, if a taxpayer purchases stock for $100 and simultaneously writes a two-year call on that stock with a strike price of $120 for $13, the taxpayer has in effect sold all of the "upside" on the stock above $120 for $13 at a time when he does not have long-term capital gain holding period. Regardless of how he chooses to settle his transactions, he arguably should be taxed accordingly. In other words, he arguably should always (i) be treated as having $13 of short-term capital gain (whether on lapse or settlement of the option or on the sale of the stock), even if he has otherwise held the stock for the long-term capital gain holding period and (ii) be required to match the character of any loss with respect to the option (*i.e.*, short-term or long-term) with the character of his gains on the stock.[61]

To illustrate the first point, suppose that at the maturity of the option the stock is worth $130. If the taxpayer sells the stock for a $30 gain that would otherwise be long-term capital gain and cash-settles the call option for a $3 short-term capital gain,[62] $10 of his gain on the sale of the stock arguably should be recharacterized as short-term capital gain. If the taxpayer instead settles the option by physical delivery, $13 of his $33 gain should be recharacterized as short-term capital gain. To illustrate the second point, assume instead that in the above example the stock is worth $160 at maturity of the option. If the taxpayer cash-settles the option for what would otherwise be a $27 short-term capital loss,

---

[60] (...continued)
unwarranted. Thus, if the benefit of a favorable holding-period rule is limited to cases where a taxpayer writes a relatively short-term call with respect to personal property such as stock, the problem may not be worth solving. Implicitly, Congress reached such a decision when it enacted the qualified covered call rules.

[61] This latter provision would not be required if our version of the Capitalization Proposal were adopted, as any such loss would be capitalized into the basis of the offsetting property and thus treated appropriately on the sale or disposition of such property.

[62] The conclusion that, under current law, gain on the option is short-term is required both by Treas. Reg. Section 1.1092(b)-2T(a), which provides generally that a taxpayer has no holding period in an asset held as part of a straddle, and by Section 1234(b), which provides that gain or loss from the closing of an option by the grantor is short-term capital gain or loss. Although outside the scope of this paper, we question whether the rule of Section 1234(b) represents sound tax policy. If a written option is "covered" (*e.g.*, by actively traded stock) and thus is a component of a straddle, the taxpayer will not receive long-term capital gain holding period in the option by virtue of the application of the straddle holding-period rule. However, we believe that a taxpayer who writes an uncovered or "naked" option with a term in excess of one year has taken substantial risk with respect to a capital transaction, and we see no basis for denying long-term capital gain holding period with respect to the settlement of such option.

the loss should arguably be recharacterized in full as long-term capital loss.[63] If he then sells the stock for $160, $13 of his gain should arguably be recharacterized as short-term capital gain, as discussed above. In sum, the net long-term capital gain on the sale of the stock and simultaneous close-out of the call arguably should never exceed $20 (the portion of the gain on the stock that was not transferred, economically speaking, by the writing of the call option with a strike price of $120).

B. The "Substantial Diminution" Standard.

The straddle rules do not currently specify what is meant by a "substantial diminution of the risk of loss" from holding a position. Section 246(c)(4)(C), on the other hand, reduces the requisite holding period for entitlement to the dividends-received deduction "for any period . . . in which . . . under regulations . . ., a taxpayer has diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property." Treasury Regulations Section 1.246-5(b)(2) provides that, "[a] taxpayer has diminished its risk of loss on its stock by holding positions with respect to substantially similar or related property if changes in the fair market value of the stock and the positions are reasonably expected to vary inversely." Arguably, a "substantial diminution" of the risk of loss, as required under the straddle rules, is different from a "diminution," which is required for purposes of determining the dividends-received deduction holding period, but the intended distinction, if any, and the rationale for such a distinction are unclear.[64]

Section 246(c)(4)(C) provides that a corporate taxpayer is not entitled to the dividends-received deduction to the extent that, under regulations, it has diminished its risk of loss with respect to its stock during a specified period of time surrounding the relevant dividend date "by holding 1 or more other positions with respect to substantially similar or related property." The legislative history of Section 246(c)(4)(C) states that the "substantially similar or related" standard is not satisfied merely because an investor acquires a position that reflects a portfolio of stocks to hedge "general market risk."[65]

Treasury Regulations Section 1.246-5, which implements the "substantially similar or related property" rule, is incorporated by reference in Treasury Regulations Section 1.1092(d)-2 (in both its final and its proposed

---

[63] Again, no specific provision would be required to ensure this result if a capitalization proposal were implemented. *See supra* note 61.

[64] *See, e.g.*, 1995 Report, *supra* note 28, at 19.

[65] H.R. CONF. REP. NO. 861, 98th Cong., 2d Sess. 818-19 (1984).

forms), and thus provides guidance on when stock and another position or positions constitute a straddle under current law. Under the standard of Treasury Regulations Section 1.246-5, stock held by the taxpayer and a "portfolio position" held by the taxpayer (defined as a position reflecting the value of 20 or more stocks) do not constitute a straddle unless either (i) there is "substantial overlap" between the taxpayer's stock holdings and the portfolio position or (ii) changes in the value of the position are reasonably expected to "virtually track" changes in the value of the stock and there was a principal purpose to obtain tax savings significantly in excess of expected pre-tax economic profit. Even if the Stock-Exception Proposal is adopted, we strongly question whether any "position" should be viewed as a straddle with respect to stock held by the taxpayer if the position would not result in tolling of holding period for purposes of the analysis under Section 246.

Guidance as to what constitutes a "substantial diminution" of risk of loss, perhaps by cross-reference to the regulations under Section 246(c)(4)(C), would be helpful – particularly if the Stock-Exception Proposal is enacted. In fact, the regulations under of Section 246(c)(4) might themselves be identified as a source of guidance in this area (at least with respect to straddles one leg of which is stock), pending the issuance of regulations that modify this regime prospectively, if at all.

We note that "short" portfolio positions, such as a put option or "short" futures contract on the S&P 500 stock index will reduce the risk of loss with respect to the taxpayer's stock in the sense of protecting the taxpayer against a general market downturn, the risk of which is an appreciable component of the risk of almost all equity securities. Nonetheless, if the resulting risk diminution is not sufficient to toll holding period under Section 246, we see no persuasive reason why it should trigger application of the straddle rules, in light of the uncertainty and complexity this would entail.[66] If taxpayers cannot rely on this standard, at least pending the finalization of regulations implementing the repeal of the stock exception, then we would oppose the Stock-Exception Proposal on the ground that it would produce an unacceptable level of uncertainty regarding application of the straddle rules to stock.

VI. Scope of Section 263(g)

Section 263(g) was enacted in response to a number of well-publicized "cash and carry straddle" transactions. A "cash and carry straddle" was a transaction in which a taxpayer would borrow money to purchase a commodity

[66] *See infra* note 94.

and agree to sell such commodity in a later year for its "forward price."[67] Since the forward price of an actively traded commodity is essentially a function of the time value of money and the cost of transporting, storing and insuring the commodity, the taxpayer's return on the straddle would match almost precisely its expenses (including interest payments). For example, a taxpayer could borrow \$100 at an 8% interest rate to purchase \$100 worth of gold today, simultaneously agreeing to sell the gold two years from now for \$120.[68] The taxpayer would pay and deduct \$8 of interest and approximately \$2 of other expenses in each of years 1 and 2. In year 2, taxpayer would also have \$20 of (long-term capital) gain. Thus, taxpayer would shelter approximately \$10 of ordinary income in years 1 and 2, paying tax (at a substantially lower rate) on \$20 of long-term capital gain in year 2. Generally speaking, the taxpayer would have had no material economic exposure at any time during this transaction.

The availability of current interest and expense deductions matching almost exactly the gain recognized on settlement of the gain position of the straddle permitted two abuses: The deferral of ordinary income (because it is sheltered by interest and expense deductions) and its conversion into capital gain (because the gain position will reflect almost exactly the income so deferred and will have been held, virtually risk-free, for the long-term holding period).

Section 263(g)(1) states that:

> no deduction shall be allowed for interest and carrying charges properly allocable to personal property which is part of a straddle (as defined in section 1092(c)). Any amount not allowable as a deduction by reason of the preceding sentence shall be chargeable to the capital account with respect to the personal property to which such amount relates.

For this purpose, "interest and carrying charges" is defined as the excess of "interest on indebtedness incurred or continued to purchase or carry the personal property" (which includes amounts paid or incurred in connection with personal property used in a short sale) plus "all other amounts (including charges to insure, store or transport the personal property) paid or incurred to carry the personal

---

[67] The term "cash and carry" derives from the nature of the transaction — a taxpayer would use borrowed money to purchase a physical commodity in the "cash market" (*i.e.*, for cash on a current delivery basis) and "carry" (that is, transport, store and insure) the commodity until the pre-determined date of future sale.

[68] The amount of gold sold forward might be greater than the amount purchased, if the gold could be lent during the "carrying" phase in exchange for "in-kind" payments of gold "interest." This does not, however, alter the basic tax arbitrage outlined in the text.

property" over the sum of certain amounts included in income with respect to such personal property for the taxable year (*e.g.*, interest, original issue discount and related items, the taxed portion of any dividends received on the property and any includible payments with respect to certain security loans).[69]

The scope of Section 263(g) has been the subject of a great deal of debate. Specifically, much has been written about the meaning of the phrases "properly allocable" and "incurred to purchase or carry," with no satisfactory resolution of these critical issues. Most practitioners agree that, absent more definitive guidance, authorities under a similar provision, Section 265(a)(2), are relevant to a determination of several of these issues,[70] although neither the policy of Section 265(a)(2) nor its operation necessarily corresponds with that of Section 263(g).

Section 265(a)(2) disallows any deduction for "interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle." Whether the proceeds of a loan are used to purchase or carry tax-exempt obligation is largely determined by the facts and circumstances. Deductions are disallowed only upon a showing of a purpose by the taxpayer to use borrowed funds to purchase or carry tax-exempt securities.[71] Such a purpose may be established by direct or circumstantial evidence.[72]

Direct evidence of a purpose to purchase tax-exempt obligations exists where the proceeds of the indebtedness are used for, and are directly traceable to,

---

[69] Section 263(g)(2).

[70] *See, e.g.*, David P. Hariton, *Colloquium on Financial Instruments: The Tax Treatment of Hedged Positions in Stock: What Hath Technical Analysis Wrought?*, 50 Tax L. Rev. 803, 814 (Summer 1995); Mary L. Harmon & Daniel P. Breen, *A Practical Guide to Equity Monetization, in* 13 Practising Law Institute, *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings*, 885, 901 (1999 ed.) [hereinafter *PLI*]; Edward D. Kleinbard & Erika W. Nijenhuis, *Everything I Know About New Financial Products I Learned from DECS*, in 12 PLI 1171, 1202-06; Diana L. Wollman, *PHONES: Wall Street's Version of Call Waiting – What Are They and How Are They Taxed, in* 13 PLI 337, 376-82.

[71] *See, e.g.*, H.R. REP. NO. 426, 99th Cong., 1st Sess. 584 (1985) ("In general, when a taxpayer has independent business or personal reasons for incurring or continuing debt, the taxpayer has been allowed an interest deduction regardless of his tax-exempt holdings.")

[72] *See* Rev. Proc. 72-18, 1972-1 C.B. 740, § 3.01.

the purchase of tax-exempt obligations.[73] Direct evidence of a purpose to carry tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness.[74]

In the absence of direct evidence linking indebtedness with the purchase or carrying of tax-exempt obligations, Section 265(a)(2) will apply only if the facts and circumstances establish a "sufficiently direct relationship" between the borrowing and the investment in tax-exempt obligations.[75] Rev. Proc. 72-18 provides guidelines for the application of Section 265(a)(2) in the absence of direct evidence for the purpose to purchase or carry tax-exempt obligations. For corporations that are not dealers in tax-exempt obligations, a purpose to carry tax-exempt obligations generally will be inferred, unless rebutted by other evidence, where the taxpayer could "reasonably have foreseen at the time of purchasing the tax-exempt obligations that indebtedness probably would have to be incurred to meet future economic needs of the corporation of an ordinary, recurrent variety."[76] To rebut such a presumption, the taxpayer must "demonstrate that business reasons unrelated to the purchase or carrying of tax-exempt obligations dominated the transaction."[77] If, however, a corporation could discharge indebtedness, in whole or in part, by liquidating its holdings of tax-exempt obligations without

---

[73] *Wynn v. United States*, 411 F.2d 614 (3d Cir. 1969), *cert. denied*, 396 U.S. 1008 (1970).

[74] Rev. Proc. 72-18, *supra* note 72, § 3.03; *The Wisconsin Cheeseman, Inc. v. United States*, 388 F.2d 420, 422 (7th Cir. 1968) ("[O]ne who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position.").

[75] *See Wisconsin Cheeseman*, *supra* note 74, at 422. The taxpayer in *Wisconsin Cheeseman* incurred a loan secured by a mortgage on real estate to finance the building of a new plant. Short-term bank loans were also incurred to meet its recurring need for working capital. The taxpayer carried tax-exempt bonds and used these bonds as collateral for the short-term bank loans. The court found that the short-term bank loans were incurred for the purpose of carrying the tax-exempt bonds because the use of the tax-exempt bonds as collateral established direct evidence of the purpose to carry. Interest deduction on the mortgage loan was, however, allowed. A distinction was made between loans borrowed to meet future economic needs of an "ordinary, recurrent variety" which was the purpose of the short-term bank loan, and loans incurred to fund a "major, non-recurrent expenditure" which was the purpose of the mortgage loan. Because the taxpayer could not have sold the tax-exempt bonds to pay for the plant without having insufficient liquid assets and difficulty in borrowing to meet its seasonal needs, the court concluded that a "reasonable person" would not sacrifice liquidity and security by selling the tax-exempts in lieu of incurring mortgage debt to finance a new plant. The court found that "business reasons dominated the mortgaging of the property," and there is "an insufficient relationship between the mortgage indebtedness" and the holding of tax-exempts.

[76] Rev. Proc. 72-18, *supra* note 72, § 6.02.

[77] *Id.*

"withdrawing any capital which is committed to, or held in reserve for, the corporation's regular business activities," the purpose to carry such tax-exempt obligations could be inferred.[78] Other arguably acceptable situations for not liquidating the tax-exempt obligations include where such holdings are required as a condition to perform a contract,[79] where the obligations are nonnegotiable obligations acquired in payment for services performed for, or goods supplied to, state or local government,[80] and where an entity in the business of attracting deposits is legally required to retain securities to meet reserve requirements.[81]

A. Guidance on the Proper Scope of Section 263(g).

It is not clear to us to what extent Section 265 and the authorities relating thereto should be considered relevant for purposes of Section 263(g). In any event, we welcome the 263(g) Proposal as an occasion to consider the rationale for, and appropriate scope of, Section 263(g).

1. Policy Bases for the Application of Section 263(g).

At a very general level, there are at least three distinct, albeit overlapping, policy bases for the application of Section 263(g). Those bases include prohibiting taxpayers from deducting interest on indebtedness incurred to purchase or carry (i) "conversion transactions," (ii) property the value of which has been protected or preserved, or (iii) appreciated property that has been economically "monetized" without current gain recognition. Each of these policies will be discussed in more detail in the following paragraphs.

The clearest justification for the application of Section 263(g) is that taxpayers should not be permitted to deduct interest on indebtedness incurred to enter into "conversion transactions" as defined in Section 1258 (the vast majority of which are also straddles).[82] A "conversion transaction" means any transaction

---

[78] *Id.*

[79] *See Commissioner v. Bagley & Sewall Co.*, 221 F.2d 944 (2d Cir. 1955).

[80] *See R.B. George Machinery Co.*, 26 B.T.A. 594 (1932).

[81] *See Investors Diversified Servs., Inc. v. United States*, 575 F.2d 843 (Ct. Cl. 1978).

[82] Section 1258, which was enacted in 1993, provides generally that gain recognized on the disposition or termination of a position that was held as part of a conversion transaction will be treated as ordinary income to the extent it does not exceed "the applicable imputed income amount" (the amount of interest which would have accrued on the taxpayer's net investment in the conversion transaction for the period ending on the date of such disposition or other termination –

(continued...)

substantially all of the taxpayer's expected return from which is attributable to the time value of the taxpayer's net investment in the transaction and that is one of the following: (i) substantially contemporaneously acquiring property and entering into a contract to sell such property (or substantially identical property) at a price determined in accordance with the contract; (ii) an "applicable straddle," which is defined as any straddle within the meaning of the straddle rules, without regard for the stock exception;[83] (iii) any transaction marketed or sold as producing capital gains from a transaction substantially all of the expected return from which is attributable to the time value of the taxpayer's net investment, or (iv) any other transaction specified in regulations.

A conversion transaction (*e.g.*, a physical position coupled with a forward) can be viewed as a "synthetic bond" which generates a "locked-in" increase in untaxed value that economically offsets the accretion of interest expense on debt incurred to purchase or carry the "synthetic bond." While Section 1258 operates generally to convert what would otherwise be capital gain with respect to the sale or exchange of a part of a "conversion transaction" into ordinary income, to the extent (roughly) of the time-value component of such gain, it does not impute accrual of income to taxpayers who hold conversion transactions. Section 263(g), however, has an effect quite similar to the accrual of income with respect to conversion transactions.[84] By disallowing current deductions for interest paid on indebtedness incurred to purchase or carry conversion transactions, Section 263(g) effectively matches the economic accrual of "income" from the conversion transaction with the "associated" or "offsetting" interest deduction, thus eliminating what would otherwise be an unwarranted tax shelter.

We believe that the matching of income and expense relating to conversion transactions is an important policy objective. Section 263(g) applies only to a subset of all conversion transactions, however (*i.e.*, applicable straddles, which are limited to offsetting positions with respect to actively traded property). We see no policy reason for this limitation on the scope of Section 263(g), and

---

[82] (...continued)
or if earlier, the date the conversion transaction ceases to exist – generally compounded at 120% of the applicable federal rate, but reduced by the amount treated as ordinary income under the conversion transaction rules with respect to prior dispositions or terminations held as part of the conversion transaction).

[83] Accordingly, if the stock exception is repealed, Section 1258(d)(1), defining an "applicable straddle," should be repealed and Section 1258(c)(2)(B) should be amended to provide simply that a conversion transaction includes any straddle.

[84] Indeed, Section 263(g) was originally enacted to prohibit deductions for interest paid in connection with leveraged "cash and carry straddles," which would be conversion transactions under current law.

accordingly recommend that interest on debt incurred or continued to purchase or carry a part of a conversion transaction, as well as all other costs and expenses paid or incurred in connection with such conversion transaction, should be capitalized.

The discussion that follows outlines two other possible rationales for broader application of Section 263(g), which we believe are worthy of consideration. Either such rationale, standing alone, might be viewed as less compelling than the "core" case of conversion transactions and might warrant limitations on the applicability of Section 263(g). However, when viewed in combination we believe that these rationales generally support a fairly broad application of Section 263(g).

The first such rationale is that taxpayers should not be permitted to deduct items incurred in connection with protecting or preserving the value of assets (such as, for example, the premium paid for a put option that protects against the decline in value of an asset held by the taxpayer), on the theory that such outlays are in the nature of capital expenditures. Many such outlays with respect to straddles could appropriately be capitalized, as discussed above in Part IV.C, by treating all economic losses incurred in connection with risk-reduced straddle positions as straddle losses that are capitalized into the basis of the offsetting positions. However, interest and expenses that are not properly viewed as straddle losses might nonetheless be viewed as "transaction costs" incurred to protect the value of, or to facilitate the retention of, an asset held by the taxpayer, and thus as appropriately subject to capitalization.

A second possible policy basis for the application of Section 263(g) is deterrence of the monetization of appreciated positions without recognition of gain. Although this differs from what we understand to have been the original purpose of Section 263(g) (which applies to indebtedness incurred either to purchase or to carry straddle property, and, as the reference to "purchase" makes clear, does not rest on whether the taxpayer holds appreciated property), this is a plausible justification for the application of Section 263(g) on a going-forward basis.[85]

---

[85] However, to the extent this rationale supports capitalization of interest and expenses under Section 263(g), an issue arises as to the amount of such interest and expenses that would be properly capitalized. For example, suppose a taxpayer borrows $100 and pledges $100 worth of stock and a put option with respect to such stock as collateral for the loan. If monetization without gain recognition is the appropriate justification for the application of Section 263(g) to interest on the debt, then the amount of interest subject to capitalization arguably should be a function of the amount of built-in gain inherent in the stock at the time of the loan. If the taxpayer has a $40 basis in the stock, then the taxpayer has "locked in" and monetized only $60 of gain with respect to the (continued...)

It is also worth noting that Section 263(g) has the peculiar consequence of treating those who borrow in connection with conversion transactions, risk reduction and monetization strategies more harshly than those who lock in a gain substantially equal to the time value of money, protect the value of assets or defer capital-gains tax with respect to risk-reduced positions, but do not monetize those positions. In other words, Section 263(g) as currently drafted acts as something of a blunt instrument: If one wished to deter conversion transactions, risk-reduction transactions or monetization strategies, one might consider adopting regimes to appropriately tax such transactions in the first instance, without regard to whether such transactions happen to be leveraged. An entirely reasonable response is that any such changes would add further complexity to an already overly complex Code.

One could also question why, if the policy rationales for application of Section 263(g) to cases other than conversion transactions are viewed as persuasive, these rationales only apply in the context of offsetting positions with respect to actively traded personal property. For instance, a nonrecourse loan secured by a building with a value in excess of its tax basis has considerable economic resemblance to a loan secured by appreciated actively traded property (*e.g.*, stock) and a put. A plausible response is that positions with respect to actively traded property are highly liquid, with the results that (i) tax-motivated structuring is easier to achieve with low transactional "friction" and (ii) the taxpayer generally has the inexpensive (apart from tax considerations) alternative of simply selling the property.

2. Meaning of "Properly Allocable."

After deciding the appropriate scope of Section 263(g) as a fundamental policy matter, one must further determine under what factual circumstances that Section should apply. To begin, consider an instrument such as a "DECS" or a

---

[85] (...continued)
stock, and thus arguably only 60% of the interest on the debt should be capitalized.

Another, although arguably less analytically sound, approach would be to "fill up the cup" and capitalize all interest on the debt until the stock has a basis of $100 (*i.e.*, the first $60 of interest. This resembles a deferred "mark to market" approach to the recognition of gain with respect to the appreciated stock which, it could be argued, is not appropriate if the taxpayer has not constructively sold the stock. Rather, one might argue that a monetization and deferral justification for Section 263(g) supports a "corrective" approach that merely prohibits deductions for amounts *incurred* to monetize unrealized gain (*i.e.*, interest incurred with respect to the portion of the borrowing in excess of the basis of the property).

similar debt-forward unit containing a variable-delivery forward contract.[86] Suppose that the forward seller does not pledge the underlying stock as collateral for its obligations under the DECS or the unit. How should this structure be treated for purposes of Section 263(g)?

First, it is clear that the forward seller has reduced its risk of loss with respect to the underlying stock and has received cash in the same transaction, whether or not it has pledged the stock to support its obligations. It is equally clear that the overall transaction permits the taxpayer to hold the underlying stock with little or no risk for an extended period of time and to enjoy the benefit of some appreciation in that stock (whether or not it was appreciated at the time of the transaction), while simultaneously permitting tax deferral and (absent application of Section 263(g)) a deduction for the interest incurred. Perhaps most importantly, the debt appears to facilitate the reduction of the forward seller's risk of loss with respect to the underlying stock, by permitting the forward seller to issue a risk-reducing instrument (the forward contract) and simultaneously receive cash from the holder of the forward contract by issuance of a debt instrument that effectively ensures the forward purchaser's performance.

Assuming that the scope of Section 263(g) should not be limited to conversion transactions, we think that the appropriate rationale for capitalization on these particular facts would be that the issuance of the debt was integral, rather than incidental, to the reduction of the taxpayer's risk of loss with respect to the underlying stock. In a meaningful economic sense, the debt itself reduces the taxpayer's risk of loss with respect to the stock, because it provides cash equal to the value of the stock that will, economically, be repaid in the form of delivery of some or all of the stock (or equivalent cash value) at a future date. This integral relationship between the debt and the taxpayer's risk reduction with respect to a straddle position suggests that interest on the debt could appropriately be subject to capitalization.

Unless a risk-reducing transaction facilitates a borrowing (as when stock and a put are pledged to support a debt instrument), or a borrowing facilitates or is inseparable from a risk-reducing transaction (as in the preceding paragraphs), the policy basis for capitalization is not clear. We view Section 263(g) as a relatively targeted provision that does not (and should not, absent much more far-reaching

---

[86] In the case where the issuer's debt is documented as a separate instrument, we assume that the debt issued to the forward purchaser is pledged by the forward purchaser to support its performance under the forward. We assume also, solely for the sake of discussion, that the collateral debt instrument, if separately issued, would be treated as debt for federal income tax purposes, and that the coupon on a DECS would be treated as interest on a deposit. Thus, we will refer to the "debt" without distinguishing between the two cases (without intending to express a view that the two situations would necessarily be treated the same for tax accounting purposes).

reforms) treat all interest as fungible and partly allocable to a taxpayer's straddle positions. Thus, we see no persuasive reason why merely borrowing contemporaneously with a risk-reduction transaction should be within the purview of Section 263(g), even if for a similar period of time and perhaps even if from the same counterparty.

B. Application of Section 263(g) Only to "Risk-reduced" Property.

As we have discussed above, Section 263(g) applies to capitalize interest and carrying charges properly allocable to personal property that is part of a straddle.[87] As discussed in Part V, above, we do not believe that it is appropriate to capitalize such costs and expenses where the taxpayer has not substantially diminished the risk of loss with respect to such property. Thus, for example, if a taxpayer borrows money to purchase stock and writes an out-of-the-money call option on that stock with a reasonably short term to maturity, we do not believe that the taxpayer should generally be viewed as having reduced her risk of loss with respect to such stock. Therefore, we do not believe that she should be required to capitalize interest paid or accrued in connection with such borrowing. The same result should obtain if the taxpayer pledges appreciated stock as collateral for a loan while that stock is subject to an out-of-the-money written call option with a reasonably short term to maturity.[88]

There is a point, however, where, because of the length of the term of an optionally exchangeable debt instrument, just as in the case of a long-term written call option, the premium for the embedded written call option would be so significant as a percentage of the current value of the cover stock that the taxpayer should be viewed as having substantially diminished her risk of loss with respect

[87] An interesting issue is whether or not "personal property" for this purpose means personal property as defined in Section 1092(d)(1), *i.e.*, actively traded personal property. Given that Section 263(g) was enacted at the same time as Section 1092, it is reasonable to infer that this was intended (*i.e.*, that interest capitalization was originally intended to apply to actively traded personal property, such as physical commodities, held by the taxpayer rather than to "positions" with respect to actively traded personal property if the positions were themselves non-traded and therefore less liquid). Whatever the original intent may have been, however, today non-publicly traded derivatives with respect to personal property (*e.g.*, over-the-counter options and forward contracts) can be valued, entered into and disposed of with relative ease (with a securities dealer as counterparty), and thus it is no longer appropriate to exclude such assets from the scope of any capitalization regime.

[88] As discussed in Part IV.C, above, to the extent that the interest on short-term contingent debt is attributable to projected appreciation in the value of underlying stock held by the taxpayer, such interest could be capitalized, not under Section 263(g), but as a loss under the basic straddle rules. Whether or not capitalization under Section 1092 applies, however, we do not believe Section 263(g) should apply if risk of loss on the stock is not substantially diminished.

to the cover stock. In those circumstances, it is quite plausible to view the cash component of the interest paid on the instrument, as well as the "phantom" deduction required by the CPDI rules, as a cost of "carrying" the underlying property, by monetizing its value and at the same time reducing its risk of loss.[89]

VII. Analysis of the Proposals

A. *Repeal of Stock Exception*

We generally support in principle the repeal of the stock exception in Section 1092(d)(3). A similar proposal was made by the Clinton Administration in 1997 and 1999 and was not enacted. We agree that "tax-motivated straddling in stock options or stock is just as objectionable as the straddling in other actively traded property that occurred prior to the enactment of the loss-deferral rule."[90] Moreover, we believe that, in light of Proposed Treasury Regulations Section 1.1092(d)-2[91] and the enactment of Section 1259,[92] the stock exception retains only limited practical efficacy. Finally, it entails a number of historical and anachronistic ambiguities that needlessly add to the overall complexity of the straddle rules.

However, while we support the repeal of the stock exception, we think it essential that Congress provide at least preliminary guidance, coupled with regulatory authority for Treasury to address the issue, as to when stock and other positions constitute a straddle and when the risk of loss with respect to stock is

---

[89] Note that if Section 1092 capitalization is applied to "phantom" deductions with respect to contingent payment debt instruments, it would appear necessary to treat a portion of the interest on the debt as subject to the capitalization under Section 1092 and the balance as potentially subject to capitalization under Section 263(g).

[90] *See* H.R. REP. NO. 432 (Part II), 98th Cong., 2d Sess. 1266 (1984).

[91] As discussed in prior reports, proposed Treasury Regulations Section 1.1092(d)-2 interprets the stock exception in such a way that the exception appears to apply only to direct positions in stock and short sales of stock. *See, e.g.*, 1995 Report, *supra* note 28, at 13 ("[T]he most plausible interpretation of the parenthetical '(other than stock)' appears to be the one adopted in the Proposed Regulation — that it excludes direct ownership of stock or a short sale of stock but includes any other position with respect to [substantially similar or related property].''). While we have expressed skepticism as to the strength of this interpretation, *see id.* (calling the interpretation "strained"), we agree with the conclusion reached and believe that it is both "plausible" and within the Treasury's authority in interpreting the Code.

[92] The enactment of Section 1259 largely eliminates the viability of the only transaction clearly falling within the scope of the stock exception (as interpreted by the Treasury), a short sale against the box.

substantially diminished.[93] For example, if a taxpayer holds a portfolio of equity positions, none of which is in the S&P 500 Index, and hedges the market risk inherent in that portfolio by entering into the short leg of an S&P futures contract, it is quite possible that a substantial amount of the taxpayer's risk of loss with respect to its long portfolio is eliminated by virtue of the S&P futures contract. We do not believe that this, without more, is sufficient reason to treat the futures contract as a straddle with respect to the taxpayer's portfolio, because of the ambiguity and complexity of applying Section 1092 in such a context.[94] We therefore think that Congress should consider affirming the general principle that a taxpayer has not substantially diminished its risk of loss with respect to stock for purposes of the straddle rules by virtue of holding any position that would not toll holding period for purposes of receiving the dividends-received deduction under Section 246.[95]

B. Debt as Interest in Personal Property.

The Debt-Straddle Proposal would provide that if a taxpayer issues a debt instrument one or more payments on which are linked to the value of personal property, the taxpayer's obligation under the debt instrument is an interest in personal property and may constitute a leg of a straddle. For example, if a taxpayer holds a long position in actively-traded stock and issues a debt instrument that contains an embedded written call, the taxpayer's obligation under

[93] As we have indicated throughout this report, we do not view these questions as co-extensive: stock can be a part of a straddle whether or not its risk of loss is substantially diminished.

[94] *See* Part V.B, above. If the S&P futures contract were to be viewed as a straddle with the taxpayer's stock holdings, and if the notional value of the futures contract were less than the value of the taxpayer's stock holdings, determining which portion of the taxpayer's portfolio was hedged would be difficult. In addition, given that the futures contract would be marked to market under Section 1256, issues would arise regarding the unfairness of a "one-way ratchet" in which mark-to-market losses were capitalized while mark-to-market gains were recognized. *See also supra* note 47. Further, depending on what rules were adopted, the taxpayer could, each time its stock holdings change, be required to mark to market the futures contract, value its stock holdings to determine unrealized appreciation, capitalize any losses into the basis of offsetting positions and identify new straddle property (or rely on any default identification rule adopted).

[95] If the stock exception were repealed, one corollary would be that it would appear to be appropriate to repeal Section 263(h), which requires capitalization of substitute-dividend payments incurred in connection with short-term or hedged short sales of stock. Because stock and a short sale of stock would be considered a straddle, such payments should be capitalized under Section 263(g), to the extent appropriate, as expenses incurred to purchase or carry part of a straddle.

the debt instrument is an interest in the stock and the two positions would therefore constitute a straddle.[96] We support the Debt-Straddle Proposal.

C. Capitalization of Loss into Basis of Offsetting Positions.

The Capitalization proposal would:

> provide that loss recognized on one leg of a straddle would be capitalized into the other leg of the straddle. This capitalization would operate as an ordering rule eliminating the need for an identification rule when the legs are of different sizes. In cases where the losses must be allocated between two or more positions that, together, constitute a single leg of a straddle, the proposal would require loss to be allocated first to the position that would generate the most gain (or income) if terminated for its fair market value. . . . In cases where the losses recognized exceed the unrealized gain (or income) in the other leg of the straddle, the excess losses would be recognized currently.

To the extent that the Capitalization Proposal represents a proposal to capitalize straddle losses rather than defer them, as discussed in Part IV.B, we support this Proposal. Otherwise, as discussed in Part IV.A, we strongly oppose the Proposal's treatment of unbalanced straddles, which is not necessary to (and, indeed, runs counter to) the principle of matching straddle-period gains and losses, which we view as the underlying rationale of Section 1092. As stated in Part IV.A, we would favor a capitalization proposal that required a taxpayer to capitalize a straddle loss into the basis of offsetting items properly identified by the taxpayer at the time of entry into the straddle, in proportion to the unrealized straddle-period gains with respect to the identified items. Treasury should have authority to determine whether the kind and amount of property identified is reasonable.

D. Mark-to-Market on Physical Settlement of Straddle Positions.

The Mark-to-Market Proposal would:

> require a taxpayer that settles an option or forward contract by delivering property to treat the settlement as a two-step transaction

[96] Again, however, we do not view this conclusion as determinative of whether the holding-period and interest-capitalization rules should apply with respect to the stock, as to which the analysis should turn on whether the debt instrument has the effect of substantially diminishing the taxpayer's risk of loss with respect to the stock. *See* Parts V and VI.B.

for purposes of applying the straddle rules. Specifically, the taxpayer would be required to treat the option or forward contract as if it were terminated for its fair market value immediately before the settlement.

We agree with the Mark-to-Market Proposal, provided that the proportionate capitalization component of the Capitalization Proposal, described above, is not adopted.[97]

E. Provide Rules for Capitalization of Interest Attributable to Straddle Positions.

The 263(g) Proposal would:

clarify the situations in which interest and carrying charges are considered properly allocable to a straddle and, therefore, must be capitalized. Specifically, the proposal would clarify that interest is considered properly allocable to a straddle if the interest accrued on a straddle-related debt instrument. For this purpose, a straddle-related debt instrument would be: (1) a debt instrument the proceeds from which are used to directly or indirectly purchase an interest in property that constitutes all or part of one leg of the straddle, (2) a debt instrument that is secured by an interest in property that constitutes all or part of one leg of the straddle, (3) a debt instrument that is issued in connection with the creation of an interest in property that constitutes all or part of one leg of the straddle (for example, debt that is separated from a swap contract under '1.446-3(g)(4)), or (4) a debt instrument that is itself an interest in property that constitutes all or part of one leg of the straddle.

---

[97] In the context of an appropriate regime for dealing with unbalanced straddles, *see* Part IV.A, *supra*, the Mark-to-Market Proposal operates to eliminate a particular type of transaction that arguably accelerates straddle losses inappropriately, not by allowing such losses to be recognized in advance of the recognition of gains in offsetting positions but by allowing them to offset and thus reduce *pre-straddle-period* gains. Thus, in effect, straddle losses can be recognized in advance of the recognition of an appropriate amount of *straddle-period* gains. We acknowledge the potential for this acceleration and recognize that the Mark-to-Market Proposal would eliminate this loophole. We note, however, that the Proposal clearly adds an amount of complexity to the straddle rules. Moreover, the Mark-to-Market Proposal would apply to DECS (and similar transactions), which do not appear to involve the inappropriate acceleration of straddle losses, because the amount of property delivered in a typical DECS transaction has more unrealized straddle-period gain than any straddle loss associated with the DECS itself.

We support a modified form of this Proposal. As discussed in Part VI.B, we do not believe that the Proposal, or Section 263(g) generally, should apply in situations involving property with respect to which the taxpayer has not substantially diminished his risk of loss. Moreover, as discussed in Part VI.A, we think it appropriate to treat indebtedness as issued "in connection with" the creation of a straddle only if the indebtedness and the straddle are integrally related. Finally, we would propose to expand the scope of either clause (2) or clause (3) of the definition of a straddle-related debt instrument, dealing with debt secured by straddle property and debt that is integrally related to the creation of a straddle position, to explicitly include structures in which debt is made structurally nonrecourse to the taxpayer, such as through the use of partnerships and other special purpose entities.

VIII. Technical Changes

A. Review of Section 1233

Section 1233 generally provides rules dealing with gains and losses from short sales. Section 1233(a) provides that gain or loss from the short sale of property is treated as capital gain or loss to the extent that the property used to close the short sale constitutes a capital asset (the "short-sale character rule"). Section 1233(b) provides generally with respect to a short sale of a capital asset (including for this purpose a purchased fixed-price put option) that if substantially identical property has been held for one year or less (without regard to the period of the short sale), then (1) gain from closing the short sale will be short-term capital gain (the "short-sale gain rule") and (2) the holding period of the substantially identical property will begin on the earlier of the date of the closing of the short sale and the date of disposition of the property (the "short-sale holding-period rule"). Section 1233(c) provides an exception from Section 1233(b) (the "married put rule") for a purchased put option acquired on the same day as the property identified as intended to be used in exercising the option, if the option is exercised (if at all) through the sale of the property. Section 1233(d) provides that losses on the closing of a short sale will be long-term capital losses if on the date of the short sale substantially identical property was held by the taxpayer for more than one year (the "short-sale loss rule").

The short-sale character rule of Section 1233(a) would appear to be superfluous in light of the enactment of Section 1234A, which provides that gain or loss from the cancellation, lapse, expiration or other termination of a right or obligation with respect to a capital asset will be treated as gain or loss from the sale of a capital asset. As they relate to short sales of actively traded assets other than stock, and as they relate to put options with respect to actively traded stock, the other provisions of Section 1233 are largely superseded by Section 1092. If the stock exception to the straddle rules is repealed, Section 1233 would appear to be superseded entirely as it relates to actively traded property.[98] Thus, to the extent that it is viewed as desirable to continue to apply the short-sale rules to non-actively traded property, it might be appropriate to consider the repeal of Section 1233 and the expansion of the straddle rules to cover nonactively traded property in certain circumstances. For example, we would support the enactment of a provision under the straddle rules authorizing the Secretary to apply the straddle rules to nonactively traded property where necessary to prevent abuse.

We are of the view, however, that regardless of whether Section 1233 generally is repealed, Congress should "re-introduce" and indeed broaden the married put rule of Section 1233(c). The married put rule was in effect eliminated from the Code, as it relates to actively traded property, by the straddle rules.[99] In the 1986 Report, we supported a proposal to add a "married put" exception (as well as a "married call" and a "married straddle" exception) to the holding-period rule of Treasury Regulations Section 1.1092(b)-2T(a). We continue to believe that there is no potential for aging short-term capital gain without risk by acquiring two straddle positions simultaneously, provided certain conditions are met, and thus that it is appropriate to incorporate a "married straddle" exception into the straddle holding-period rule.[100]

In conclusion, if the stock exception is repealed, Section 1233 would have limited continuing relevance. In that event, it might be advisable to direct

---

[98] *See* SMC, *supra* note 45, ¶ 29.

[99] *See, e.g.*, Tax Section, New York State Bar Ass'n, *Report on a Legislative Proposal on the Federal Tax Treatment of Certain Transactions Involving Listed Option Contracts* (July 18, 1986) [hereinafter *1986 Report*], *reprinted in* 86 Tax Notes Today 158-46 (Aug. 8, 1986).

[100] To the extent that risk is effectively eliminated, the transaction should constitute a conversion transaction, in which case any concern regarding character conversion would be addressed by Section 1258. However, if married straddles were exempted from the straddle holding-period rule, we are of the view that a special rule would be advisable in order to prevent "selectivity" in cases such as the following: Suppose that a taxpayer purchased a share of stock for $100 and a two-year put with a strike price of $100 for $20. At maturity, if the stock were worth $85 and the straddle holding-period rule did not apply, the taxpayer would have a $20 long-term capital loss on the delivery of the stock into the put option for $100. If, however, the taxpayer "broke" the married put, settling the put for cash and selling the stock separately, he would have a $5 capital loss on the settlement of the put and a $15 capital loss on the sale of the stock, each of which would be short-term capital loss under Section 1233(b). Thus, in the case where the married put would generate a net loss, the taxpayer could elect whether to take long-term or short-term capital loss. This result would be most easily avoided by requiring the taxpayer who has identified a married put (or, more generally, if our proposal is adopted, a married straddle) to mark his positions to market at such time as the marriage is broken, with any net loss resulting not subject to the short-term rules of Section 1233(b).

Treasury to study the effects of repealing that provision and the possible conforming changes to the straddle rules discussed above.

B. Repeal Qualified Covered Call Option and Identified Straddle Rules.

We recommend the repeal of the qualified covered call option exception. We believe that exception is both underinclusive (in that it applies only to certain types of exchange-listed options,[101] while its basic principle should apply more broadly to any "covered" written option or optionally exchangeable security, provided there has not been substantial diminution of risk of loss with respect to the "cover stock") and overbroad (in that the exception permits the recognition of losses with respect to the cash settlement of a written call option in advance of the recognition of associated straddle-period gains with respect to the cover stock).

In addition, we recommend that the identified straddle rules of Section 1092(a)(2) be repealed. The regime is of little practical consequence in any event, providing only that a position that is not part of an identified straddle is not offsetting with respect to part of an identified straddle. Although it is true that the identified straddle rule also purports to provide that the loss-deferral rule does not apply to an identified straddle, in fact this conclusion is somewhat tautological — an identified straddle is by definition one all of the positions of which are disposed of on the same day, so that, absent offsetting positions that are not part of the identified straddle, there are never "unrecognized gains" in "offsetting positions" to which the loss-deferral rule could apply. Once a taxpayer is permitted to identify offsetting positions in all cases, as we have proposed, the identified straddle regime essentially provides no additional protection and thus should be repealed.

C. Modify Definition of "Position."

We recommend that the concept of a "position" be modified. In its current form, the definition provides that a position means "an interest (including a futures or forward contract or option) in personal property." Moreover, the straddle rules provide that a taxpayer "holds" offsetting positions if there is a substantial diminution of the risk of loss from "holding" a position by reason of "holding" another position. It is conceptually difficult to describe a liability, such as an obligor's obligation under a debt instrument or a short position, as something that one "holds." We believe that a more precise definition of "position" should be adopted, such as:

---

[101] *See supra* note 16.

the rights and obligations of any party to a contract or instrument the value of which is determined in whole or in part by reference to the value of, or changes in the value of, personal property.[102]

D. *Modify Holding-Period Loss Rule.*

Consideration should be given to amending the holding-period loss rule, perhaps by regulation. The rule provides that any loss on a straddle position is treated as long-term capital loss if on the day such loss position is *entered into* all gain or loss with respect to one or more positions in such straddle would be long-term capital gain or loss.[103] We do not believe that this rule achieves the appropriate result in many cases, because we believe that the policy behind the holding-period loss rule is to require matching of the holding period of the loss position with the holding period of offsetting gain positions.

For example, suppose taxpayer has owned a put option on stock, with a strike price of $50, for more than one year (the "old put"). At a time when the stock is worth $100, the taxpayer purchases the stock and pays $9 to purchase a "put spread" protecting it from risk of loss in the stock between $100 per share and $50 per share. If the stock increases in value and the "put spread" expires unexercised, the current rule would provide that the resulting $9 loss is a long-term capital loss, because one of the positions in the straddle on the day the put spread was acquired, the old put, had a long-term holding period. However, there is no economic or policy basis for treating this loss as a long-term capital loss, because the "offsetting position" — the stock — has a short-term capital gain holding period, by virtue of Treasury Regulations Section 1.1092(b)-2T(a).

Thus, the holding-period loss rule should provide that any loss on a straddle position is treated as long-term capital loss if (or, more appropriately, to the extent that) on the day such loss is *realized* all gain or loss with respect to one or more of the offsetting positions with respect to such loss position would be long-term capital gain or loss.

---

[102] Alternatively, or additionally, Congress might consider modifying the definition of offsetting positions to provide that the focus is on whether a taxpayer "has" a position rather than whether the taxpayer "holds" a position.

[103] Treas. Reg. Section 1.1092(b)-2T(b) (emphasis added).

E. Definition of "Unrecognized Gain."

If a capitalization rule is *not* enacted and the straddle rules continue to operate on the basis of unrecognized gains in offsetting positions, the straddle rules should be modified (by legislation or regulation) to make clear that, for purposes of determining the amount of such unrecognized gain, an offsetting position remains an offsetting position, regardless of any subsequent modification, amendment, alteration or disposition thereof, to the extent that unrecognized straddle-period gain with respect to such position has not either been recognized by the taxpayer or eliminated as a result of subsequent decreases in value while the taxpayer remains the tax owner of such position. This modification is intended to eliminate several arguments that taxpayers might make that, we believe, should be foreclosed.

For example, a taxpayer might argue that contributing offsetting positions to charitable organizations eliminates the unrecognized gain in such positions. Section 1092(a)(3)(A)(ii) provides that "unrecognized gain" includes the amount of gain realized, "in the case of any position with respect to which, at the close of the taxable year, gain has been realized but not recognized." No gain is recognized when appreciated property is donated or is contributed to a charitable organization. It is not clear whether under general principles of tax law it could be argued that such gain is "realized." If not, such gain would not be "unrecognized gain" within the meaning of Section 1092(a)(3)(A), and the loss would not thereafter be subject to the straddle rules. We believe that this is not an appropriate result from a policy perspective and that the argument should therefore be foreclosed.

Alternatively, a taxpayer might take the position that a subsequent tax-free modification to the terms of an offsetting position, either pursuant to its terms or as a result of a nonrecognition transaction, has the effect of making such positions no longer offsetting and therefore eliminates unrecognized gain in offsetting positions. As a policy matter, the issue is whether the positions were offsetting at the time the loss was realized, not whether the built-in gain position retains its character as "offsetting" with respect to the loss position once the loss has been realized. Thus, this argument should be foreclosed as well.

In addition, we think that it should be made clear that "unrecognized gain" is not limited to amounts that would be treated as capital gain if an offsetting position were disposed of. For example, if a taxpayer hedges a nonqualified stock option with respect to actively traded stock and terminates the hedge at a loss, the loss probably should be deferred to the extent of unrecognized straddle-period appreciation in the option, notwithstanding that such appreciation would be accounted for as compensation if the option were disposed of. Moreover, if a taxpayer hedges a stock position with a debt instrument and the price of the stock subsequently declines, so that the taxpayer sells the stock at a loss, unrecognized cancellation of indebtedness income or negative adjustments in the offsetting debt instrument should operate to defer the loss.[104]

F. Positions Held by Related Persons.

Section 1092(d)(4)(B) defines a "related person" as (i) a spouse or (ii) a member of the taxpayer's consolidated group of corporations. We believe that this definition is inappropriately narrow and that it should be expanded to encompass the relationships set forth in Sections 267(b) and 707(b). Somewhat counterintuitively, with respect to stock straddles, Treasury Regulations Section 1.246-5(c)(6) defines a related person by reference to Sections 267(b) and 707(b) if the taxpayer has a view to avoiding the application of Treasury Regulations Section 1.1092(d)-2.[105] We do not believe that this broad definition of a related person should be limited to stock positions.

In addition, suppose that a taxpayer contributes appreciated property to a wholly owned corporation, Straddleco (which might, for instance, be a tax haven vehicle as to which a "qualified electing fund" election is made), and Straddleco

---

[104] To implement these proposals, Section 1092(a)(3)(A), which defines "unrecognized gain," could be amended to provide that:

> (i) The term "unrecognized gain" means, with respect to any offsetting position held by the taxpayer as of the close of the taxable year, the amount of gain or other income which would be taken into account with respect to such position if such position were sold or terminated on the last business day of such taxable year at its fair market value.
>
> (ii) For purposes of applying subsections (a)(1)(A) and (a)(3)(A)(i) (but not for purposes of section (c) hereof), an offsetting position includes any position the basis of which was determined in whole or in part by reference to the basis of a position that was an offsetting position with respect to one or more positions from which the loss arose.
>
> (iii) If an offsetting position is disposed of by any donative transfer, then, except to the extent that the taxpayer obtains permission from the Secretary to use a different method of accounting, the taxpayer shall be treated as holding such offsetting position as of the close of such taxable year and each succeeding taxable year with an amount of unrecognized gain equal to the excess of the amount so claimed over the taxpayer's basis in such offsetting position.

[105] Perhaps more puzzling, Treasury Regulations Section 1.246-5(c)(6) applies a lookthrough rule with respect to passthrough entities, intermediaries or other arrangements if the taxpayer holds an interest in or is the beneficiary of such entity or arrangement with a view to avoiding the application of Treasury Regulations Section 1.1092(d)-2. However, Section 1092(d)(4)(C) provides a lookthrough rule, at least with respect to trusts and partnerships, in all events and without regard to the taxpayer's view. Note that technical guidance will be needed regarding the application of a capitalization rule for straddle losses in a related-party context.

then enters into a collar with respect to such stock. Under current law, a strong case can be made that the taxpayer may pledge the stock of Straddleco as collateral with respect to a borrowing by the taxpayer, and interest incurred with respect to such borrowing will be currently deductible. The straddle rules currently provide in Section 1092(d)(4)(A) that "[i]n determining whether 2 or more positions are offsetting, the taxpayer shall be treated as holding any position held by a related person." A related person includes the taxpayer's spouse and any member of the taxpayer's consolidated group of corporations. The stock and the collar are clearly offsetting, but this does not lead to the conclusion that the Straddleco stock is a straddle position. Section 1092(d)(3)(B)(ii) provides that stock of a corporation formed or availed of to take positions offsetting the taxpayer's positions is personal property, but the taxpayer has no position that is offset by Straddleco's assets.

We think that this argument should be foreclosed. Thus, it should be made explicit that for purposes of Section 263(g), stock of a corporation formed or availed of to enter into straddles shall be deemed to be personal property that is part of a straddle.

G. Definition of "Interest and Carrying Charges."

Section 263(g) defines "interest and carrying charges" that are subject to capitalization as the excess of interest and carrying charges (as defined) over the sum of certain amounts of income with respect to the relevant straddle property for the taxable year. We think that this definition of income should be broadened to encompass not only income with respect to the "purchased or carried" straddle property but also any income with respect to the offsetting, or hedging, position. For example, interest on a loan embedded in a swap that reduces the risk of loss with respect to, and is collateralized by, the taxpayer's stock should not be capitalized to the extent that the taxpayer is receiving or accruing LIBOR-based payments under the swap for the taxable year.