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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED "STRADDLE" REGULATIONS

September 5, 2001

Introduction[1]

This report responds to Treasury's proposed "straddle" regulations promulgated on January 18, 2001. The regulations include three main proposals (each a "Proposal"):[2]

(1) The first Proposal (the "Capitalization Proposal") would mandate that all otherwise deductible payments or accruals with respect to indebtedness, financing transactions or other financial instruments that are used to purchase or carry straddle property must be capitalized into the basis of the straddle property, including ordering rules for determining the property the basis of which should be increased by the capitalized items.

(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 "QCC Proposal") would modify the qualified covered call ("QCC") rules of Section 1092(c)(4) by including certain over-the-counter and nonstandardized options within the definition but limiting the term of any option that is a QCC to one year or less.[3]

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

(1) We have a number of concerns regarding the scope and application of the Capitalization Proposal, beginning with the question whether, given its apparent scope, the proposed reform is an appropriate exercise of regulatory authority or more properly a subject of legislation.

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

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[1] The principal author of this Report is Michael Farber. Helpful comments were received from Sam Dimon, David Hariton, Lucy Farr, Bob Jacobs, Richard Reinhold, David Schizer, Michael Schler and Paul Wysocki.

[2] This Report does not comment upon the extent to which each of the topics addressed in the Treasury's proposed regulations better be described as a "modification" or "clarification" of current law.

[3] Section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the regulations thereunder.

(3) We generally agree with the QCC Proposal as an interim measure, but suggest changes to the definition of persons with whom a qualifying over-the-counter option may be "entered into."

I. Overview

This report responds to the proposed regulations (primarily the Capitalization Proposal), partly by reference to our March 2000 report on the then Administration's proposed legislation relating to the straddle rules (the "2000 Report"). While, overall, we view the proposed regulations as a marginally helpful first step in rationalizing the application of the straddle rules, we continue to believe there is more work to be done and that it would be appropriate for Congress again to consider straddle rules modifications, as discussed in our 2000 Report.

In particular, the Capitalization Proposal might be interpreted to convert most otherwise-deferrable straddle losses into items capitalized under Section 263(g). This approach would expand the scope of the Section 263(g) regime to items that we believe are not "interest or carrying charges" as originally contemplated by Congress. In our 2000 Report we expressed general support for a regime for capitalizing straddle losses. Thus, we would not oppose the expansion of the capitalization regime to encompass straddle losses, but we believe that it would be more appropriate for Congress to implement such a regime by amending Section 1092. Moreover, we note that, absent legislative reform of Section 1092, the Capitalization Proposal would leave intact the deferral regime of Section 1092 when there is no "straddle property" at the time a loss is realized. We believe this "two-track" approach would frustrate the goal of simplification.

On a more positive note, applying the Capitalization Proposal to straddle losses would offer taxpayers a mechanism for effectively identifying which portion of an "unbalanced" straddle position will be the subject of capitalization in many cases. We believe, however, that this issue could be addressed directly without regard to capitalization.[4]

On a technical level, we believe that the Capitalization Proposal itself is flawed in several respects. First, it draws an unnecessary distinction between "indebtedness and other financings" and other types of financial instruments. This raises several concerns relating to the Proposal's scope and application. Moreover, the Proposal does not adequately address the concept of "matching" straddle positions with the offsetting straddle property for purposes of

[4] We note that Treasury Priority Guidance Plan for 2001 includes a project to address issues relating to unbalanced straddles.

capitalization or otherwise provide any rules for legging into or out of the "identification" regime provided by the proposed regulations, so that it may be possible for taxpayers to use these rules to circumvent the Proposal's intent. In addition, we view certain Proposal provisions as vague and potentially overbroad.

Finally, we continue to believe the straddle rules otherwise need clarification or reform in a number of respects. For example, the proposed regulations do not address whether the holding period rules apply only to the property into which capitalizable items are capitalized, so that taxpayers must grapple with the unsettled state of "prior" law under Section 1092. While this issue could be addressed by regulations, other reforms discussed in the 2000 Report would require legislation.

II. Summary

A. Current Law.

Part III of this report restates the summary of the straddle rules included in the 2000 Report.

B. The Capitalization Proposal.

In Part IV, we discuss the Capitalization Proposal and conclude the proposal is in some respects conceptually meritorious, but a number of issues require further consideration. In addition to questioning the appropriateness of the apparently dramatic expansion of Section 263(g) by regulatory action, rather than legislation, we think that (i) the ordering rules relating to capitalization should not distinguish between payments and accruals with respect to "indebtedness and other financing" and those with respect to other financial instruments that are used to purchase or carry straddle property; (ii) the effective "identification" regime resulting from the capitalization ordering rules is subject to abuse absent either an antiabuse rule or a detailed regime addressing the need to match an appropriate kind and amount of straddle property with the offsetting position that is generating otherwise-deductible payments or accruals, as well as a rule for legging into and out of the proposed identification regime; (iii) it is desirable to clarify further when interest on an indebtedness or other financing will be subject to capitalization; (iv) it is desirable to clarify when a financial instrument "purchases or carries" straddle property; and (v) a number of technical issues should be addressed.

C. The QCC and Debt-Straddle Proposals.

In Part V, we briefly discuss the QCC and Debt-Straddle Proposals. We believe the QCC Proposal generally is an appropriate interim measure, but suggest changes to the definition of persons with whom a qualifying over-the-counter option may be "entered into." We support the Debt-Straddle Proposal for the reasons stated in the 2000 Report.

D. Additional Straddle Issues.

In Part VI, we identify a number of issues under the straddle rules that remain unresolved by the proposed regulations, including issues relating to the application of the straddle holding period rules to positions that are part of an "unbalanced" straddle and the application of the straddle rules to non-risk-reduced positions.

III. The Straddle Rules

Section 1092(c)(1) defines a straddle as offsetting positions[5] with respect to personal property.[6] 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.[7] For purposes of these rules, stock generally is 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 that stock or substantially identical stock or securities[8] or (ii) under regulations, a position with respect to substantially similar or related property (other than stock)[9] or (b) stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.[10]

The straddle rules generally do not apply to hedging transactions defined in Section 1256(e)[11] or to stock and "qualified covered call options."[12] The loss-

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

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

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

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

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

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

[11] Section 1092(e). A hedging transaction is defined in Section 1256(e) by reference to Section 1221(b)(2)(A), which in turn defines a hedging transaction as one entered into in the normal course of a trade or business primarily to manage the risk of price changes or currency (...continued)

deferral rule (described below) does not apply to "identified straddles."[13] 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 straddle rules primary consequences are: First, any loss attributable to a straddle position is taken into account in any taxable year only to the extent that loss is in excess of "the unrecognized gain (if any) with respect to 1 or more positions which were offsetting positions" with respect to the loss position (the "loss-deferral rule").[14] 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 the position was held for the long-term capital gain holding period prior to entering the straddle (the "holding-period rule").[15] Third, 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 the property, must be capitalized rather than currently deducted (the "interest-capitalization rule") under Section 263(g).[16]

(continued...)

fluctuations with respect to ordinary 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 ordinary obligations incurred or to be incurred. To qualify as a hedging transaction for purposes of Section 1259(e), a transaction must be clearly identified as such before the end of the day it is entered into.

[12] A QCC 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 QCC 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 QCC 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 QCC, 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)(1)-(2). The exemption from the straddle rules only applies if all of the offsetting positions making up a straddle consist of QCC's and the underlying stock, and the straddle is not part of a larger straddle. Section 1092(c)(4)(A). Treasury has regulatory authority to modify the QCC rules. Section 1092(c)(4)(H).

[13] Section 1092(a)(2)(B).

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

[15] 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 the loss position is entered into all gain or loss with respect to one or more positions in the straddle would be long-term capital gain or loss. Section 1.1092(b)-2T(b).

[16] 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. Treas. Reg. Section 1.1092(b)-1T; *see also* S. REP. NO. 144, 97th Cong., 1st Sess. 149 (1981)
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IV. The Capitalization Proposal

A. Summary of the Capitalization Proposal.

As explained in more detail below, the Capitalization Proposal generally defines "personal property" for purposes of Section 263(g), as well as "interest and carrying charges properly allocable" thereto, and would also provide rules for allocating such interest and carrying charges to the personal property.

"Personal property" would be defined as any property, whether or not actively traded,[17] that is not real property, but would exclude positions, such as written put or call options and issued indebtedness, that impose obligations but do not confer substantial rights on the taxpayer.[18] For purposes of this Report, unless otherwise indicated, we will use the term "personal property" to refer to personal property, as defined in Proposed Treasury Regulations Section 1.263(g)-2, that is part of a straddle.

"Interest and carrying charges" would include:

- "[o]therwise deductible payments or accruals . . . on indebtedness or other financing issued or continued to purchase or carry personal property"[19] and

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("Thus, in most cases, the disallowance of losses under the section 1091 rule functions merely to defer the loss.").

[17] This definition contrasts with the definition of "personal property" for purposes of the basic straddle rules of Section 1092, which defines "personal property" as personal property of a type that is actively traded. The examples in the proposed regulations make clear that "personal property" for purposes of Section 263(g) would include privately issued trust certificates and partnership interests and short positions under commodity forward contracts.

[18] Prop. Treas. Reg. Section 1.263(g)-2. This raises the interesting question of whether a prepaid forward or a short sale is "personal property." Both confer no ongoing rights upon the taxpayer, because she has received the proceeds of the ultimate sale at inception; however, both carry the potential for substantial economic benefit for the taxpayer, in the event the price of the underlying property declines in value. Capitalizing a straddle loss into the basis of such a position presents the conceptually difficult issue of "negative basis", because both prepaid forwards and short sales constitute "liabilities" for purposes of the Code. *See, e.g., Salina Partnership v. Comm'r,* T.C.M. (CCH) 352 (2000) (holding that a partnership's obligation to return securities "sold short" is a liability for purposes of Code Section 752); Rev. Rul. 95-26, 1995-1 C.B. 131 (same); Rev. Rul. 95-45, 1995-1 C.B. 53 (a short seller's obligation to return borrowed securities is a liability for purposes of Sections 357 and 358); Rev. Rul. 88-77, 1988-2 C.B. 128.

[19] Prop. Treas. Reg. Section 1.263(g)-3(b)(1).

- "[o]therwise deductible payments or accruals on financial instruments that are part of a straddle or that carry part of a straddle."[20]

These terms are further defined as follows. "Indebtedness or other financing issued or continued to purchase or carry personal property" would include indebtedness or other financing:

- the proceeds of which are "used directly or indirectly" to purchase or carry personal property;
- that is secured directly or indirectly by personal property; or
- the payments on which are determined by reference to payments with respect to, the value of, or the change in value of, personal property.[21]

"Financial instruments that are part of a straddle or that carry part of a straddle" would include a financial instrument:

- that is part of a straddle;
- that is issued in connection with the creation or acquisition of a position in personal property;
- that is sold or marketed as part of an arrangement that:
    - involves a taxpayer's position in personal property *and*
    - is purported to result in either:
        - economic realization of appreciation in an asset without simultaneous recognition of taxable income or
        - a current deduction for a payment or expense that is economically offset by an increase in value not concurrently recognized for tax purposes or that has a different tax character than the deduction;

and

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[20] Prop. Treas. Reg. Section 1.263(g)-3(b)(3). In addition, "interest and carrying charges" would include "otherwise deductible fees or expenses paid or incurred in connection with acquiring or holding personal property," such as storage, maintenance, transportation and insurance costs. Prop. Treas. Reg. Section 1.263(g)-3(b)(2).

[21] Prop. Treas. Reg. Section 1.263(g)-3(c).

- any other financial instrument if the facts and circumstances support a reasonable inference that the issuance, purchase or continuation of the instrument was intended to purchase or carry straddle property.[22]

"Interest and carrying charges" would be properly allocable to personal property to the extent those items exceed in each year the amount of "allowable income offsets," which generally include interest or other similar amounts with respect to the personal property, dividends with respect to the personal property (to the extent not subject to the dividends-received deduction), includible payments with respect to securities loans relating to the personal property and amounts includible in income with respect to a "financial instrument," to the extent the instrument is entered into to purchase or carry the personal property.[23]

Interest and carrying charges properly allocable to personal property would be subject to "allocation rules." With regard to amounts paid or accrued on "indebtedness or other financing," the interest amounts would be allocated in the following order:

- to personal property purchased, directly or indirectly, with the proceeds of the indebtedness or other financing;
- to personal property that directly or indirectly secures the indebtedness or other financing; or
- if all or a portion of the interest and carrying charges are determined by reference to the value or change in value of personal property, to the personal property.[24]

In all other cases, interest and carrying charges would be allocated to personal property "in the manner that under all the facts and circumstances is most appropriate."[25]

Finally, Section 263(g) capitalization would apply before loss deferral under Section 1092.[26]

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[22] Prop. Treas. Reg. Section 1.263(g)-3(d).

[23] Prop. Treas. Reg. Section 1.263(g)-3(a), (e).

[24] Prop. Treas. Reg. Section 1.263(g)-4(a).

[25] Prop. Treas. Reg. Section 1.263(g)-4(a)(3). Fees and expenses described in note 20 above are allocated to the personal property the acquisition or holding of which resulted in their incurrence or payment. Prop. Treas. Reg. Section 1.263(g)-4(a)(2).

[26] Prop. Treas. Reg. Section 1.263(g)-4(b).

B. Scope of the Capitalization Proposal.

Depending upon how one interprets the Capitalization Proposal language, we believe it possible the Proposal would have the effect of largely superseding the Section 1092(a) deferral regime for straddle losses, as discussed further below. Although we previously stated in our 2000 Report that we do not object to capitalization rules for straddle losses as a conceptual matter, we believe that this would be more appropriately implemented by legislation rather than regulations.

1. Application of Proposal to Straddle Losses.

Suppose Sandra owns 100 shares of ABC corporation stock, each worth $100, and enters into a 3-year, cash- or physically-settleable "cashless collar" transaction including the obligation to sell the 100 shares to the counterparty in 3 years for $120 per share if the stock is worth more than $120 (or, if Sandra elects, to pay the excess of the stock price over $120, times 100 shares) and the right to sell the shares to the counterparty in 3 years for $90 per share if the stock is worth less than $90 per share (or, if Sandra elects, to receive the excess of $90 over the stock price, times 100 shares). If at maturity the stock is worth $150 per share and Sandra elects to retain her ABC stock and cash-settle the collar, she will deliver to the counterparty $3,000 to settle her obligations thereunder.

Because the stock is "personal property" and the collar and the stock constitute a straddle, under the Capitalization Proposal, Sandra's $3,000 loss incurred to close the collar transaction must be capitalized if the collar is a "financial instrument" and the payment is an "otherwise deductible payment" with respect to that financial instrument. The term "financial instrument" is not defined in the proposed regulations, although the examples conclude that a (nonprepaid) forward contract and a notional principal contract constitute "financial instruments."[27] Thus, while additional clarity on the issue would be helpful, we believe the collar would be treated as a financial instrument under the Capitalization Proposal. Sandra's $3,000 payment to settle the collar would very likely be a capital loss under Section 1234A, which provides that gain or loss attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to a capital asset is treated as gain or loss from the sale of a capital asset.[28] Under Section 165(f), a capital loss is deductible, subject to

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[27] Prop. Treas. Reg. Section 1.263(g)-4(c), Ex. 1, 7.

[28] We note that some would argue that the "collar" is merely two options, a written call option and a purchased put option, from the taxpayer's perspective. Although we see no basis for bifurcating a single instrument in this way, *see* 2000 Report, note 44, under that characterization the loss would be capital under Section 1234(b) rather than under Section 1234A.

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limitations under Sections 1211 and 1212. Thus, it might be reasonably concluded that Sandra's $3,000 maturity payment is an "otherwise deductible payment" on a financial instrument that is part of a straddle, and thus subject to capitalization into the basis of the ABC stock.

It is not clear to us that this result is intended or that the language of the Proposal dictates this result. Because capital losses typically arise from either the sale or exchange of capital assets or the cancellation, lapse, expiration or other termination of a right or obligation with respect to capital assets, it is awkward, to say the least, to characterize capital losses as "payments or accruals."

To take an extreme case, consider a taxpayer who pays $10 for the cash-settleable right to put a $100 share of ABC stock to a counterparty for $100 in 6 months. If the option lapses, the resulting $10 loss would not ordinarily be considered a "payment or accrual." Moreover, if the stock decreases in value to $97, the taxpayer will exercise the put and *receive* $3, but will nonetheless have a loss of $7. Now consider a taxpayer who receives $83 in exchange for the cash-settleable obligation to deliver a variable fraction of the ABC share in three years. If the taxpayer delivers $90 at maturity, she will have a $7 loss on the transaction, but this loss is not clearly a "payment or accrual" in the same way that interest and carrying charges constitute payments or accruals. Suppose instead that a taxpayer buys stock for $100 and a $10 cash-settled right to put the stock to a counterparty for $100 in 6 months. If the stock declines in value to $70 after three months and the taxpayer then sells the stock for $70, she will have a $30 loss, a loss that is in no sense a "payment or accrual." A number of additional examples are discussed in Part IV.B.2, below.

If the Proposal is designed to encompass capital losses within the scope of its capitalization requirements under Section 263(g), we believe that this feature should be made clear. One way to do so would be to apply the Section 263(g) regime to "otherwise deductible amounts (including capital losses) paid, accrued or incurred with respect to indebtedness or other financing incurred or continued to purchase or carry personal property that is part of a straddle." However, the consequences of this approach should be carefully considered, as described in the next section.

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Also, some would argue that even if the collar is not treated as two options, the settlement of the collar by its terms is an "extinguishment" rather than a "cancellation, lapse, expiration or other termination," and thus is not subject to Section 1234A. This reading of Section 1234A would permit a taxpayer to sell the collar prior to its maturity if the stock price were below $90, ensuring a capital gain, but hold the collar to maturity and pay the counterparty to "extinguish" the contract if the stock price were in excess of $120, recognizing an ordinary loss. Given that Section 1234A was enacted to avoid this sort of "whipsaw", we believe this interpretation should be rejected.

2. Consequences of Broadening Section 263(g) to Include Straddle Losses.

Although, as we stated in our 2000 Report, we believe capitalization is an appropriate regime for dealing with straddle losses, we think it clear that Section 263(g) was not originally intended to act as a capitalization regime for all straddle losses, and thus the Capitalization Proposal, if it is intended to encompass capital losses, will represent a substantial broadening of the application of Section 263(g).

One obvious question in this regard is whether this broadening is an appropriate exercise of Treasury's regulatory authority. As discussed above, the Proposal may be interpreted to largely supersede Section 1092(a) as it relates to straddle losses resulting from "payments or accruals with respect to financial instruments that . . . carry part of a straddle," which might encompass most straddle losses. In Section 1092(b)(1), Congress authorized Treasury to prescribe regulations "as may be appropriate to carry out the purposes of this section and section 263(g)." We question, however, whether the Proposal is consistent with the express statutory language of Section 1092(a).

We note that under the loss deferral regime of Section 1092(a), a taxpayer need only defer straddle losses to the extent of unrecognized appreciation in offsetting positions. By contrast, under the Capitalization Proposal, a taxpayer would be required to capitalize all losses into the basis of any "personal property" that is part of the straddle, whether or not there is unrecognized gain in that property. One might argue, therefore, that the Proposal, by virtue of effectively overriding this specific congressional enactment, exceeds Treasury's authority. *See* S. REP. NO. 144, 97th Cong., 1st Sess. 148 (1981) ("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.").[29] Even apart from the question of possible invalidity, one might question whether it is appropriate to effect such a fundamental change by regulations rather than legislation.

In our 2000 Report we expressed support for a capitalization regime notwithstanding such consequences as the inability to currently deduct "net" losses. We believe this result is reasonable as a policy matter, in the interest of administrability, because under current law, taxpayers may be required to undertake the potentially difficult (and difficult to verify) task of notionally marking to market non-publicly traded "gain" positions to determine what portion of their straddle losses are currently deductible. Furthermore, to the extent that a capitalization regime produces a basis in excess of fair market value, taxpayers can generally resort to "self-help" by selling the "built-in loss" position.

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[29] *See also* H.R. REP. NO. 97-201, at 204 (1981) ("The capitalization rule applies only to cash and carry transactions structures as straddles.")

Nonetheless, it is not at all clear that straddle losses are properly considered "interest and carrying charges," to which capitalization applies under Section 263(g).[30] In any event, we believe it worth considering whether it would be more appropriate for Congress to replace Section 1092(a) with a capitalization regime for straddle losses. Congressional action is particularly desirable in light of the fact that broadening the scope of Section 263(g) by regulation does not adequately address the shortcomings of the loss deferral rule of Section 1092(a), such as the "unbalanced straddle" problem discussed in detail in the 2000 Report.[31]

In light of the increased focus recently on tax simplification, it is also worth noting that the Capitalization Proposal, even if it substantially limits the applicability of Section 1092(a), would nonetheless leave that complex regime applicable in some circumstances. For example, losses recognized with respect to straddle positions where the remaining straddle position(s) do not constitute "personal property" within the meaning of Proposed Treasury Regulations Section 1.263(g)-2 would continue to be subject to deferral under Section 1092(a). Suppose a taxpayer enters into offsetting call options with respect to the same stock, but with different maturities. Suppose that the written option has a longer term than the purchased option. If the purchased option were cash-settled at a loss (and assuming such item constitutes a "payment or accrual" otherwise subject to capitalization under the Proposal, which is not certain, as discussed above), there would be no "personal property" under Section 1.263(g)-2 into which the loss could be capitalized. Thus, the loss would be deferred under Section 1092(a) rather than capitalized under the Proposal. This situation could not be readily addressed by changes to the Capitalization Proposal without a complete legislative revision of both Sections 1092 and 263(g).

If the Capitalization Proposal is to be implemented, we believe that the treatment of losses on notional principal contracts should be modified to avoid the "one way ratchet problem" described in the 2000 Report.[32] Also, it would be helpful to clarify that items subject to capitalization under Section 263(g) are not subject to the miscellaneous itemized deduction floor of Section 67 and the itemized deduction cap of Section 68.

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[30] The preamble to the Capitalization Proposal seems to indicate that a financial instrument can "carry" offsetting personal property even if there is no net investment in the straddle. 66 FR 26283. We believe it strains the meaning of the word "carrying costs" to apply them to losses on a financial instrument in such a context.

[31] We note, however, that this issue could be addressed by regulations. *See supra* note 4.

[32] It is quite distortive, for instance, to require capitalization of all net periodic payments made on a "short" notional principal contract position while forcing recognition of all net periodic payments received. It would seem appropriate, at a minimum, to allow recognition of net periodic swap "losses" to the extent of prior income inclusions on the swap. See Section IV.C of the 2000 Report for discussion of further possible refinements to such a regime.

C. Structure of the Capitalization Proposal.

1. <u>"Indebtedness or Other Financing" Versus "Financial Instruments."</u>

The Capitalization Proposal draws a distinction between "indebtedness and other financing" on the one hand and "financial instruments" on the other. It is not clear why this distinction is drawn, although it has a number of consequences we view as unhelpful to the operation of the proposed regulations.

First, we note that one consequence of this distinction is that it permits taxpayers to argue that certain arrangements are neither "indebtedness or other financings" to which the rules relate nor "financial instruments," thus potentially avoiding the application of the Proposal in circumstances to which its application seems most directed. For instance, suppose a taxpayer issues an instrument such as a DECS, PEPS, MEDS or another "mandatorily exchangeable" instrument tied to the value of portfolio stock held by the issuing taxpayer. Many taxpayers characterize these instruments as consisting of a "straight" deposit or debt instrument and a nonprepaid forward contract to sell a variable number of shares of the portfolio stock. Alternatively, suppose a taxpayer issues "straight" debt in a unit with a forward contract in the portfolio stock, in a manner similar to packaged instruments such as FELINE PRIDES or ACES. Taxpayers typically do not pledge the portfolio stock as collateral for their obligations under these instruments if the instrument is publicly offered.

In these circumstances, the issuing taxpayer may argue that the interest he pays or accrues on the "straight" debt component of the instrument is not subject to capitalization. A possible argument for this result is that the Proposal distinguishes "indebtedness or other financing" from "financial instruments," suggesting that a single position cannot be both an "indebtedness or other financing" and a "financial instrument." Thus, if something is an indebtedness that is not described in Proposed Treasury Regulations Section 1.263(g)-3(c), then one might infer it is not described in Proposed Section 1.263(g)-3 at all and thus is not subject to the capitalization regime of the Proposal. It seems clear that in many cases the "straight" debt component of the instrument will not be described in Proposed Treasury Regulations Section 1.263(g)-3(c): *i.e.*, the proceeds are not used to purchase or carry straddle property, it is not secured by straddle property and the interest payments are not tied to the value of straddle property.

We believe capitalization is the appropriate result, and this should be made clear if the Capitalization Proposal is finalized. Moreover, the certainty of this result should not depend upon whether the security (or investment unit) in question constituted (or included as a component that constituted) indebtedness. In this regard, it would be helpful to eliminate the distinction between "indebtedness and other financings" and "financial instruments".

Furthermore, the distinction between "indebtedness or other financing" and "financial instruments" can lead to unwelcome uncertainty for taxpayers, without any discernible economic or policy basis. Under Proposed Treasury Regulations Section 1.263(g)-4, a taxpayer who enters into an indebtedness or other financing may manage the capitalization consequences of her transaction. For example, suppose a taxpayer has 100 shares of ABC stock worth $100 each and enters into a cash- or stock-settleable prepaid forward contract to sell a variable number of shares determined by reference to the price of the ABC stock on the settlement date, but not more than 20 ABC shares, in three years. Specifically, suppose the taxpayer agrees to deliver 16.67 shares if the stock is worth in excess of $120 per share, 20 shares if the stock is worth less than $100 per share, and a number of shares with a value equal to $2,000 (20 shares times $100 per share) if the stock is worth between $100 and $120 per share. In exchange, the counterparty makes a prepayment at inception of $1,660 ($83 times the maximum number of number of deliverable shares, 20), which the taxpayer does not use to acquire straddle property. Suppose the taxpayer pledges 20 shares as collateral to secure her obligations to deliver a variable number of shares at maturity of the contract. If at maturity the stock is worth $120 per share and the taxpayer chooses to cash-settle, the taxpayer would deliver to the counterparty $2,000 ($120 times 16.67 shares deliverable), resulting in a loss of $340 ($2,000 - $1,660).

The contract would appear to constitute a "financing" because the taxpayer has raised funds in what is appropriately viewed as an open transaction requiring the taxpayer to deliver property at a later date. Accordingly, the taxpayer's $340 loss on the cash-settlement of the contract (again, assuming that the loss results from a "payment or accrual" under the contract, which is not clear under the Proposal but which we believe should be made clear) would be capitalized into the basis of the 20 shares pledged as collateral with respect to the contract and not into the taxpayer's remaining 80 "free" shares.

Now, suppose instead the taxpayer entered into a "collar" transaction with the identical economics, except that the taxpayer is not prepaid at inception; instead, the taxpayer agrees to pay the counterparty the amount by which the value of 16.67 shares at maturity exceeds $120 per share, and is entitled to receive from the counterparty an amount by which the value of 20 shares at maturity is less than $100 per share. In this transaction, the taxpayer is in a similar economic position with respect to the ABC stock as the taxpayer who enters into the prepaid forward contract described above. The difference is that the taxpayer in this example has not, economically, "borrowed" any funds. If the taxpayer in this example pledges 20 shares as collateral to support his obligations under the collar, he will not be entitled to the benefit of the clear capitalization rule of Proposed Treasury Regulations Section 1.263(g)-4(a). Instead, because the collar is not an "indebtedness or other financing," but is likely a "financial instrument" within the meaning of the Proposal, he will be required to capitalize any loss from the settlement of the collar into "personal property that is part of a straddle in the manner that under all the facts and circumstances is most appropriate."[33]

It seems very likely that in this case the taxpayer would be permitted to capitalize his loss into the 20 pledged shares; however, this result is less certain than in the case of the prepaid forward described above. It seems clear to us that the treatment of these two transactions should be the same. We thus recommend that the distinction drawn in the ordering rules of Proposed Treasury Regulations Section 1.263(g)-4 be eliminated and all instruments subject to the regime be subjected to the same ordering rules.

2. Matching and Legging Rules.

The Capitalization Proposal fails to provide rules for determining the straddle property to which an "indebtedness or other financing" or a "financial instrument" properly relates. Under Proposed Treasury Regulations Section 1.263(g)-4, losses and other expenses incurred with respect to indebtedness or other financings are allocated (i) first to the straddle property, if any, purchased directly or indirectly with the proceeds of the indebtedness or other financing; (ii) then to straddle property, if any, that is part of the straddle and that directly or indirectly secures the indebtedness or other financing; and (iii) then to the property, if any, the value or change in value of which determines the amount of the interest or carrying charges with respect to the indebtedness or other financing, with all other interest and carrying charges allocated to straddle property in the manner that under all the facts and circumstances is most appropriate.

This formulation raises a number of issues, in addition to the concern addressed above that we see no reason to distinguish between "financial instruments" and "indebtedness or other financings". First, the allocation regime of Proposed Treasury Regulations Section 1.263(g)-4 does not provide rules to ensure that capitalizable items are allocated to an appropriate amount of straddle property. Second, the rules do not provide for "legging into" or "legging out of" the identification regime proposed by Proposed Treasury Regulations Section 1.263(g)-4. Thus, taxpayers may attempt to take advantage of this uncertainty by taking positions that achieve unintended and potentially abusive results. We illustrate these issues further below, through the use of a series of hypothetical transactions.

For instance, suppose a taxpayer owns 200 shares of RST stock each worth $1 and issues a 30-year debt instrument, similar to what is commonly known as a "PHONES," pursuant to which the taxpayer receives $100 at inception in exchange for an obligation to pay (i) annually a 2% coupon plus the

[33] Prop. Treas. Reg. Section 1.263(g)-4(a)(3).

amount of any dividends paid on 100 shares of the RST stock during any year and (ii) at maturity, \$100 plus the excess of the value of 100 shares RST of stock over \$120. Assume the taxpayer does not use the proceeds of the instrument to acquire straddle property and does not pledge the RST stock as collateral for its obligations under the instrument. Under Proposed Treasury Regulations Section 1.263(g)-4(a)(1)(iii), if the interest on the instrument is "determined by reference to the value . . . of personal property," the taxpayer will be required to capitalize that interest into the basis of that property.[34]

The Proposal does not state how the allocation rule would operate in this instance, where the taxpayer owns 200 RST shares but the value of only 100 shares determines the amount of interest payable on the instrument. Is the taxpayer permitted to identify which of her 200 shares will be allocated the interest? Can she identify shares with a basis in excess of fair market value? Is there any possibility the Service could argue the interest should be capitalized into the basis of all 200 of the taxpayer's shares, a result we think inappropriate, both under the plain language of Proposed Section 1.263(g)-4(a)(1)(iii) and as a matter of tax policy?

Suppose instead that, at the time the above instrument is issued, the taxpayer pledges one share of RST stock as collateral for her obligations under the instrument. Presumably, it is not intended that all the interest accruing on the instrument would be capitalized into the basis of this one share. Otherwise, the taxpayer could sell the share at year-end, pledge another share, and so forth, thus circumventing the regime.

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[34] We note here a minor technical issue: None of the interest *accruing* on the instrument is determined by reference to the value of any RST stock; under Treasury Regulations Section 1.1275-4, the amount of the accruals is determined by reference to the taxpayer's estimated borrowing cost on a comparable noncontingent debt instrument. It is generally, although not entirely, true that a portion of the aggregate interest ultimately *payable* on the instrument will be determined by reference to the value of the RST stock. For example, if the stock price at maturity is less than \$1.20 per share, none of the interest on the instrument (other than the interest accrual for the year the instrument matures, which will be offset by the negative adjustment on retirement of the instrument) will be determined by reference to the value of RST stock. There can be no real doubt that interest accruing on the debt instrument is capitalized into the stock, given Example 5 in Proposed Treasury Regulations Section 1.263(g)-4(c). However, it might be preferable to amend Proposed Treasury Regulations Section 1.263(g)-4(a)(1)(iii) to provide that interest or carrying charges are allocated to straddle property "if all or a portion of such interest or carrying charges are *or might reasonably be expected (as of inception)* to be determined by reference to the value or change in value of personal property." (emphasis added).

It is also not clear to us why this provision would not apply where the instrument provides for payments determined by reference to *payments with respect to* straddle property, which language is used in the definition of an "indebtedness or other financing" the interest on which is subject to capitalization. *See* Proposed Treasury Regulations Section 1.263(g)-3(c)(3). We see no basis for excluding these instruments from the ordering rules of Proposed Section 1.263(g)-4, and Proposed Treasury Regulations Section 1.263(g)-4(a)(1)(iii) should be expanded to include these instruments.

Alternatively, suppose that immediately before the maturity of the instrument, it is clear that the taxpayer will owe an amount in excess of the "projected amount" payable at the maturity of the instrument, determined as of the issue date. This payment will give rise to a "positive adjustment" that is treated as a straddle loss under Section 1.1275-4(b)(9)(vi). What if the taxpayer acquires 100 shares immediately prior to the maturity date and pledges her shares as collateral for her obligations under the instrument? Capitalizing the positive adjustment into the basis of the newly acquired shares would permit the taxpayer to circumvent the regime by selling those shares immediately after settling the debt instrument, recovering the loss.

Suppose instead the taxpayer does not pledge RST stock but uses the proceeds of the indebtedness to purchase stock of corporation FGH together with a purchased put option allowing the taxpayer to sell FGH stock in one year for a fixed price (so that the FGH stock is "straddle property"). Under Proposed Treasury Regulations Section 1.263(g)-4(a)(1)(i), the interest accruing on the instrument (including any positive adjustment at maturity) would be capitalized into the basis of the FGH stock and not into the basis of any RST stock. This makes no policy sense.

As these examples should make clear, final regulations under Section 263(g) must include provisions dealing with (i) the need to "match" interest and carrying charges with the appropriate kind and amount of straddle property and (ii) the possibility of "legging" into and out of the allocation regime of Proposed Treasury Regulations Section 1.263(g)-4. One possibility would be to allow taxpayers to identify the property into which capitalizable items would be capitalized, similar to the proposal in our 2000 Report.[35] Such a regime would require detailed limitations and "default" rules in order to address the issues raised above, which will necessarily entail a number of policy judgments.[36] In addition (or as an alternative to) to any detailed regime, it would be advisable to include an antiabuse rule, preferably with a number of examples clearly identifying the appropriate application of the ordering regime.

3. Defining Straddle-Related Instruments.

a. *Indebtedness or Other Financing.*

Proposed Treasury Regulations Section 1.263(g)-3(c) provides that an indebtedness or other financing is incurred or continued to purchase straddle

[35] See 2000 report, Part IV.A.

[36] Many of these issues have been addressed in some detail in Part VI of our 2000 Report in the context of the Clinton Administration's Year 2001 legislative proposal relating to interest capitalization.

property, and thus that the interest and other deductible items with respect to the indebtedness or other financing must be capitalized rather than currently deducted, if (1) the proceeds of the indebtedness or other financing were used directly or indirectly to purchase or carry straddle property, (2) the indebtedness is secured directly or indirectly by straddle property or (3) payments on the indebtedness or other financing are determined by reference to payments with respect to straddle property or the value or change in value of the straddle property. For the reasons discussed below, we believe the first part of this rule is vague and potentially overbroad.

Instead of this provision, we recommend consideration of the framework of the Clinton Administration's Year 2001 legislative proposal to apply the capitalization rules to "straddle-related debt," as modified by our discussion in the 2000 Report. The Year 2001 legislative proposal would have provided that interest on a "straddle-related debt instrument" would be subject to capitalization under Section 263(g). A straddle-related debt instrument would have included one (1) the proceeds from which are used directly or indirectly to purchase straddle property, (2) secured by straddle property, (3) issued in connection with the creation of a straddle position or (4) that is itself a straddle position. We view this as a much more workable standard than Proposed Treasury Regulations Section 1.263(g)-3(c), although we would add that the debt and the straddle position should be "integrally related" to trigger the capitalization rules, as discussed in Part VI.A.2 of the 2000 Report. As discussed below, some of the language of the Capitalization Proposal departs from this framework in a way that is not, in our view, an improvement.

Proposed Treasury Regulations Section 1.263(g)-3(c)(2), involving indebtedness or other financing secured directly or indirectly by straddle property, is consistent with authorities in analogous areas, and most practitioners believe that it generally is reflective of current law under Section 263(g). Also, Proposed Treasury Regulations Section 1.263(g)-3(c)(3), involving debt or other financing linked to the value of or payments with respect to straddle property, is consistent with the Year 2001 legislative proposal relating to this subject, which we supported and continue to support. The language of Proposed Treasury Regulations Section 1.263(g)-3(c)(1), involving indebtedness or other financing the proceeds of which are "used directly or indirectly to purchase or carry" straddle property, is vague and therefore more troubling. We believe that there is a risk that this language could be interpreted to require all taxpayers who hold "straddle property" to capitalize interest on any issued indebtedness into the basis of such straddle property on a *pro rata* basis.

Thus, if Proposed Treasury Regulations Section 1.263(g)-3(c) is to be retained, rather than adopting a "straddle-related debt" rule (which we believe would be preferable), we propose either eliminating any inquiry into whether the proceeds of an indebtedness or other financing are "used directly or indirectly" to "carry" straddle property, or else providing a more workable limitation of this concept, perhaps by providing one or more examples of when a taxpayer who holds straddle property and incurs indebtedness will not be required to capitalize that interest.

b. *Financial Instruments.*

As distinguished from indebtedness or other financing, Proposed Treasury Regulations Section 1.263(g)-3(d) would treat "financial instruments that are part of a straddle or that carry part of a straddle" as subject to capitalization if (1) the instrument is part of a straddle, (2) the instrument is issued in connection with the creation or acquisition of part of a straddle, (3) the instrument is sold or marketed as part of an arrangement that involves a taxpayer's position in personal property and that purports to result in either economic realization of appreciation in an asset without tax or a current deduction for amounts economically offset by an increase in value that is not taxed currently or that has a different tax character or (4) the totality of the facts and circumstances supports a reasonable inference that the issuance, purchase or continuation of the instrument was intended to purchase or carry straddle property.

As discussed below, we have some concerns about the scope of the proposed language, and recommend adopting a single standard for the application of the capitalization rules to indebtedness, other financings and other financial instruments. For instance, our straddle-related debt proposal could be expanded to include all "straddle-related instruments." Clauses (1) and (2) of Proposed Treasury Regulations Section 1.263(g)-3(d) would be subsumed within this definition. Clauses (3) and (4) could, we believe, be subsumed within the concept of an "integral relationship" between the instrument and the straddle property, which could be fleshed out by examples. Thus, we propose to replace Proposed Treasury Regulations Sections 1.263(g)-3(c) and (d) with the notion of a "straddle-related instrument."

In any event, we believe Proposed Treasury Regulations Section 1.263(g)-3(d)(4) is potentially overbroad and should be revised. That Section provides that a financial instrument carries part of a straddle "if the totality of the facts and circumstances support[s] a reasonable inference that the issuance, purchase, or continuation of the financial instrument by the taxpayer was intended to purchase or carry" personal property. This provision would appear literally to apply whether or not a financial instrument purchases or carries straddle property, and indeed, whether or not the financial instrument was *intended* to purchase or carry straddle property, provided only that the facts and circumstances *support a reasonable inference* of that intent. Under this formulation, it may be difficult for taxpayers to determine whether their transactions are subject to the capitalization regime. If our "straddle-related instrument" proposal is not adopted, the Capitalization Proposal would apply more appropriately to financial instruments if the final regulations were to replace the words "support[s] a reasonable inference" in Proposed Section 1.263(g)-3(d)(4) with "establishes."

4. Technical Issues.

In this Section, we discuss several technical issues relating to the Capitalization Proposal, including a technical issue relating to the capitalization consequences where related parties collectively hold a straddle.

a. *Related Party Issues.*

Because the straddle rules provide in certain instances that taxpayers may have a straddle by virtue of positions held by related persons,[37] consideration should be given to the operation of the Capitalization Proposal under these circumstances. Suppose a partnership holds stock and a partner who is "related" to the partnership within the meaning of Section 707(b) enters into a swap with respect to that stock. If the partner makes a net payment on the swap for a year, how should the payment be capitalized? We believe the partner should be treated as contributing the payment to the partnership, and the partnership should be required to capitalize the payment into the basis of the stock. Similarly, suppose a corporation writes a contingent debt instrument tied to the value of portfolio stock held by its consolidated subsidiary. Interest payments on the debt should be treated as contributed to the subsidiary and capitalized into the basis of the portfolio stock. Absent clarification in the regulations specifying these results, the partner in the former example and the parent in the latter may be required to capitalize the payments into the basis of the partnership interest and the subsidiary stock, respectively. In many cases that capitalization would convert an intended capitalization regime into an effective disallowance regime, an inappropriate result.

b. *Application to Compensatory Property Straddles.*

In addition, the Capitalization Proposal arguably would require capitalization of interest, carrying charges and straddle losses into the basis of compensatory property, such as nonqualified stock options and nonvested restricted stock as to which no Section 83(b) election has been made. As we stated in our 2000 Report, this interpretation would raise a number of potentially difficult collateral issues, such as the effect of the capitalization on the employee's compensation income, the employer's deduction, and payroll taxes. Also, to the extent that this interpretation of the Proposal would enable executives

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[37] *See* Section 1092(d)(4) (defining related persons to include spouses and consolidated group members); Treas. Reg. Section 1.246-5(c)(6) (providing that if positions are held by any related party, within the meaning of Section 267(b) or 707(b), or if the taxpayer holds an interest in or is the beneficiary of, a passthrough, intermediary or other arrangement, in either case with a view to avoiding the "substantially similar or related property" test of Treasury Regulations Section 1.1092(d)-2, then the taxpayer holds substantially similar or related property).

to hedge compensatory property with relatively favorable tax consequences, it would raise corporate governance issues beyond the scope of this article.[38]

One way to address these issues would be to clarify that compensatory options and forfeitable, nontransferable stock as to which no Section 83(b) election is made do not constitute "personal property" for purposes of the Proposal.

c. *Application to Commodity Traders.*

Proposed Treasury Regulations Section 1.263(g)-1(b) exempts from the scope of the Proposal "securities" to which the mark-to-market rules of Section 475 apply. Because Section 475, by virtue of Section 475(f), may also apply to commodities, the final regulations should exempt "securities or commodities" to which the 475 rules apply.

d. *Application to Mixed Straddle Accounts.*

We note the Proposal does not specify how the capitalization regime will operate in the context of "mixed straddle accounts." We recommend that the application of the Capitalization Proposal to mixed straddle accounts, which are provided for under Treasury Regulations Section 1.1092(b)-4T, be clarified in several respects. First, the Capitalization Proposal should clarify that the special interest and carrying charge allocation rules of Treasury Regulation Section 1.1092(b)-4T(c)(3) as an adjustment to the annual account net gain or loss should continue to apply to mixed straddle accounts in lieu of the allocation rules of Proposed Treasury Regulations Section 1.263(g)-4. Second, Treasury Regulations Section 1.1092(b)-4T(c)(3) should be amended to refer to the definition of interest and carrying charges set forth in Proposed Treasury Regulations Section 1.263(g)-3.

V. The QCC and Debt-Straddle Proposals

We believe the QCC Proposal, by expanding the scope of the QCC rules to include over-the-counter options, represents a significant improvement over current law, and to that extent we support it. If our suggestion to amend the straddle regime by legislation rather than regulations is accepted, the role and scope of the QCC rules could be revisited at that time.

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[38] Some would say that employees should be dissuaded from hedging compensatory property, so that perhaps a tax mismatch (which exists if income on compensatory property is ordinary and loss on a related hedge is capital) is, if inadvertently, a useful barrier to such activity. *See, e.g.*, David Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440 (2000). This issue is beyond the scope of this Report.

There is, however, a problem with the scope of the QCC Proposal as it pertains to "qualifying over-the-counter options." Under the Proposal, in order for an over-the-counter option to qualify for QCC treatment, it must be "entered into with" a person registered with the Securities and Exchange Commission (the "SEC") as either (i) a broker-dealer under Section 15 of the Securities Exchange Act of 1934 ("Section 15" and the "Exchange Act," respectively) and the regulations thereunder, or (ii) an alternative trading system under 17 CFR § 242.300 et. seq.[39] As we understand it, the purpose of this requirement is to ensure that sales of "qualifying over-the-counter calls" occur on arms-length terms with counterparties subject to adequate record-keeping requirements.[40] We have two comments in this regard. First, the requirement that a qualifying over-the-counter option be "entered into with" the enumerated persons should be changed to a requirement that the option be "entered into with or through" the enumerated persons, to make clear that such persons can act as agent and are not required to purchase the option(s) as principal. Second, we believe that the enumerated persons should include banks, which are able to act as broker-dealers with respect to options on equity securities without registering under Section 15 of the Exchange Act.[41] The best appropriate technical reference to banks (as parties with or through which qualifying over-the-counter options could be entered) is probably to a "bank within in the meaning of Section 3(a)(6) of the Securities Exchange Act of 1934 and the regulations adopted thereunder."[42] Finally, it would seem appropriate to add to the list of enumerated persons "such other persons as the Secretary may determine," so that additions can be made to the list, if that is deemed appropriate, without amending the regulation (once adopted).

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[39] Prop. Treas. Reg. Section 1.1092(c)-3(c)(2).

[40] A broker-dealer subject to registration under Section 15 is subject to record-keeping requirements set out in Rule 17a-3 under the Exchange Act. We note in passing that an alternative trading system under 17 CFR § 242.300 et. seq. is generally required to register under Section 15 of the Exchange Act, see 17 CFR § 242.301(b)(1), although this requirement is subject to exceptions set out at 17 CFR § 242.301(a), so that the reference to alternative trading systems set out at Prop. Treas. Reg. § 1.1092(c)-3(c)(2) is largely but not entirely duplicative of the reference to broker-dealers registered under the Exchange Act. It is not clear to us whether the reference to alternative trading systems in the proposed regulation serves any practical purpose.

[41] See generally Section 3(a)(4)-(5) of the Exchange Act and the related provisions in Section 206 of the Gramm-Leach-Bliley Act, P.L. 106-102. Under provisions of the Gramm-Leach-Bliley Act the effectiveness of which has been delayed by the SEC until at least 2002, banks will be required to interpose a broker-dealer registered under Section 15 of the Exchange Act in dealing with customers who are not "qualified" institutions or individuals . Banks will continue to be able to act as broker-dealers with respect to transactions in options on equity securities entered into by "qualified" persons.

[42] Such an entity, which would be subject to regulation by a banking regulatory authority in this country, would generally be subject to record-keeping requirements. See, e.g, 12 CFR Part 12, 12 CFR Part 344, and 12 CFR § 208.34.

We agree with the Debt-Straddle Proposal for reasons stated in Part VII. B of the 2000 Report.

VI. Other Issues

The Proposals do not attempt to address a number of issues raised by the 2000 Straddle Report. For example, while in many cases (as discussed in Part IV.C.1, above) the Capitalization Proposal addresses some of the unduly harsh results that can apply to "unbalanced" straddles, it does not address the collateral consequences of the straddle rules on unbalanced straddles.[43] For instance, the Proposal does not affect the application of the holding period rules of Treasury Regulations Section 1.1092(b)-2T. Suppose a taxpayer holds 100 shares of QRS stock for six months and then enters into a three-year cash-settleable variable share delivery prepaid forward contract with respect to ten QRS shares, pledging ten shares as collateral on the contract. We believe that under the Proposal any loss on the cash-settlement of the contract would be capitalized into the basis of the ten pledged shares and not the taxpayer's remaining ninety shares. However, it is not clear whether at the end of the contract the taxpayer has long-term holding period in the 90 unpledged shares, as we believe should be the case. One way to clarify this result would be to modify Treasury Regulations Section 1.1092(b)-2T(a) to provide that it applies to straddle positions only to the extent "payments or accruals" with respect to positions are or would be subject to capitalization under Treasury Regulations Section 1.263(g)-4.

In addition, the straddle rules continue to apply to all positions that are part of a straddle, whether or not the risk of loss with respect to the position is substantially diminished, as discussed briefly in Part V, above. As discussed in Parts V.A and VI.B of the 2000 Report, we believe this to be inappropriate in many cases and recommend that Congress act to correct this anomaly. Finally, we continue to believe it would be appropriate to review the continuing necessity of Section 1233, as discussed in the 2000 Report.

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[43] As discussed in note 4, above, Treasury has opened a regulations project to address the tax treatment of unbalanced straddles.