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November 11, 2005

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Re: <u>JOBS Act Straddle Amendments</u>

Dear Sirs:

This letter* is prompted by the modifications to the "straddle" rules made by the American Jobs Creation Act of 2004 (the "Jobs Act" or the "Act"). The amendments to the straddle rules include the following changes:

(1) The first set of changes overhauls the "identified straddle" rules of Code Section 1092(a)(2), broadening the ability of taxpayers to identify offsetting positions of a straddle (the "Identification Amendment"). Under the Amendment, once a taxpayer has identified a straddle, the regular straddle loss deferral rules do not apply. Instead, the loss is capitalized into

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* The principal drafters of this letter were Michael Farber and Stacy Selig, with substantial assistance from Sam Dimon and Erika Nijenhuis.

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the basis of each identified offsetting position in proportion to unrecognized "straddle period gains" in those positions. Additionally, the Act provides the Secretary with authority to issue regulations specifying the proper methods for identifying a straddle, while eliminating Treasury's express authority (in prior law Section 1092(c)(2)(B)) to address the "unbalanced straddle" problem.

(2) The second set of changes requires taxpayers to "disaggregate" the physical settlement of a straddle position that would, if cash-settled, have resulted in loss realization (the "Physical Settlement Rule"). This rule treats the physical settlement of a straddle position as a two-step transaction in which the taxpayer is deemed to have terminated the position for its fair market value immediately prior to settlement, and then to have sold for its fair market value the property used to physically settle the position.[1]

While we support in principle both of these amendments, we observe that these two provisions could be read literally to produce what we think are unintended results. Thus, technical amendments are needed to clarify the operation of the identified straddle rules in several respects, as discussed further below. While we believe that some of these amendments could be effected by regulations, there is a need for further guidance to the Treasury Department and the Internal Revenue Service in order to ensure that regulations properly implement congressional intent.

Overview

To begin, we note that the Act was intended to, and Congress clearly believed it did, resolve the "unbalanced straddle" problem of prior law, as described in our report of March 2000 (the "2000 Report").[2] In the process, the Act eliminated Section

[1] In addition, the Act also made the following changes to the straddle rules. First, it narrowed the "stock exception" of Section 1092(d)(3) (the "Stock Exception Amendment"). Aside from the exception for "qualified covered call" options, the stock exception has been eliminated. Second, it expanded the application of Section 163(*l*), which disallows deductions with respect to interest on "disqualified indebtedness," to encompass "portfolio exchangeable" debt. In the case of "portfolio indebtedness," the rule now generally provides that interest on such debt must be capitalized into the basis of the portfolio stock (the "163(*l*) Amendment"). These provisions are beyond the scope of this letter.

[2] Congress clearly understood the "unbalanced straddle" problem and intended to remedy it with the passage of the Act: "While the prior-law rules provided authority for the Secretary to issue guidance concerning unbalanced straddles, the Congress was of a view that such guidance was not forthcoming. Therefore, Congress believed that it was necessary to provide such guidance by statute." Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), at 483 (May 2005) ("JCT"). Moreover, in a footnote discussing the preservation of a rule providing that non-identified positions shall not be treated as offsetting an identified position, the JCT provides an example of the problem:

> For example, if a taxpayer holds an unbalanced straddle comprised of 100 shares of XYZ corporation and a put option on 50 shares of XYZ corporation, the taxpayer may identify 50 of the shares and the put option as an identified straddle under the Act. The identified straddle is not considered part of a larger straddle merely by virtue of the remaining (unidentified) 50 shares held by the taxpayer because such shares (which are not

1092(c)(2)(B), which expressly granted authority to the Treasury to address the unbalanced straddle problem by regulations. Accordingly, taxpayers who hold straddles where one side is larger than the other and who wish to take advantage of the Identification Amendment must look to the Act's provisions to determine their tax consequences. However, the Identification Amendment as drafted contains significant ambiguities that, taken together, may not solve the "unbalanced straddle" problem. Moreover, for a particular taxpayer who holds an unbalanced straddle, the Physical Settlement Rule amplifies the uncertainty of the Identification Amendment by preventing the taxpayer from "bypassing" the issue through physical settlement of an unbalanced straddle position.[3] Thus, while we do not object to either the Identification Amendment or the Physical Settlement Rule in principle, we think it is essential that the Identification Amendment be made to operate in a manner that resolves the unbalanced straddle problem on a self-executing basis, as Congress intended.

I. The Identification Amendment

In Section A below, we briefly discuss the ambiguities inherent in the Identification Amendment as drafted and propose (largely technical) amendments thereto that would in our view resolve these issues consistent with our understanding of congressional intent. In Section B, we discuss additional issues that we feel might be clarified by legislative history, and in any event that require further consideration. In addition, the Appendix reflects a markup of the Act's provisions effecting our proposals.

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part of the identified straddle) are not treated as offsetting with respect to the put option (which is part of the identified straddle). *Id.* at 484, n.972.

[3] As an example, assume a taxpayer who owns 100 shares of stock ABC, each worth $100 and with a basis of $0, enters into a $90-$120 "collar" with respect to 50 of those shares, but does not (or cannot) identify such shares under the Identification Amendment. Now suppose the stock increases in value to $150 per share and the client delivers 50 shares at maturity of the collar in exchange for $6,000 (50 * the $120 call "strike"). Under prior law, the taxpayer would have $6,000 of gain. Had client identified the 50 shares with the collar upon entry, she would have the same result: Under the Physical Settlement Rule, she would treat the settlement of the collar as generating a $1,500 loss (50 shares * ($150 stock value - $120 call strike)), which would be capitalized into the 50 shares delivered, resulting in $6,000 of capital gain (50 shares * $150 stock value - $1,500 stock basis capitalization). Absent identification, however, she will have $7,500 of capital gain, and $1,500 of straddle loss, and this loss will not be capitalized into the 50 shares she delivered to offset her $7,500 of gain. Indeed, it will not be capitalized into any of her shares. Rather, it will be deferred, under "old" law, until (and to the extent that) it exceeds the "unrecognized gain" in her "offsetting positions." Of course, as discussed in detail in our 2000 Report, this is precisely the "unbalanced straddle problem" – except that now the taxpayer may be forced in addition to recognize an extra $1,500 of gain on the sale of her stock (for which she has received no corresponding economic benefit). This result seems untenable to us.

A. *Technical Corrections and Clarifications*

1. *Loss Disallowance*

The Identification Amendment could be read literally to disallow permanently a loss from a position in an identified straddle where there is no unrecognized straddle-period gain with respect to any offsetting position in the identified straddle.[4] This is because new Section 1092(a)(2)(A)(ii) provides that a loss from an identified straddle position is capitalized into the basis of the identified offsetting positions in the ratio of "the unrecognized gain with respect to [each] such offsetting position" to the aggregate unrecognized gain with respect to all such positions. Thus, literally, if no offsetting position has unrecognized gain, no loss is allocated to the basis of any offsetting position. However, Section 1092(a)(2)(A)(iii) continues by providing that "any loss *described in* [Section 1092(a)(2)(A)(ii)] shall not otherwise be taken into account for purposes of this title," without regard to whether that loss was in fact capitalized into the basis of any position under the former provision. Several commentators have pointed out that a literal reading of the Identification Amendment could lead to the conclusion that if no offsetting position has unrecognized gain, the loss is disallowed. Treasury and IRS officials are reported to have made similar comments.[5] The legislative history of the Indemnification Amendment, by contrast, states that the loss disallowance provision is intended to apply only to the extent that the loss in question has in fact been capitalized.[6] As the legislative history of the Identification Amendment makes clear, the purpose of the identified straddle rule is to match straddle-period losses and gains appropriately, not to disallow altogether an economic loss.

Accordingly, we think that if there is a realized loss on a position in an identified straddle at a time when there is no straddle-period gain in any other position in the

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[4] For example, imagine a taxpayer who purchases 100 shares of stock DEF for a price of $100 each as well as a put option to sell 100 shares of DEF stock for a "strike" price of $95 each, for which she pays a premium of $5 per share, or $500, and that the taxpayer identifies such positions as an identified straddle. If at the maturity of the option the stock is worth $98 per share, the taxpayer will have a capital loss of $500 on the lapse of her option, even though she has a built-in *loss* with respect to her remaining identified straddle position (the DEF stock).

[5] *See, e.g.*, Fred Stokeld, "Officials Cite Problems With Jobs Act's Changes to Straddle Rules," 2005 TNT 196-4 (June 3, 2005).

On the other hand, some practitioners argue that these provisions can be read in a manner that does not result in disallowance of a straddle loss where there is no straddle-period gain in offsetting positions. Whatever the merits of that argument, the issue is too important to be left in its current state of ambiguity.

[6] *See* H.R. CONF. REP. NO. 108-755 (Conference Committee Report on H.R. 4520) (Under the Indemnification Amendment, "[a]ny loss with respect to an identified straddle cannot otherwise be taken into account by the taxpayer or any other person *to the extent that the tax loss increases the basis of any identified positions* that offset the loss positions in the identified straddle.") (emphasis added).

identified straddle, Section 1092(a)(2)(A) should be amended to clarify how that loss is treated. Clarification should address two questions. The first question is whether such losses may be deducted currently,[7] or whether instead such losses are required to be capitalized, as the statute requires in those cases where there is some straddle-period gain in an offsetting position. Second, assuming capitalization is required, the second question is how such losses should be allocated among the other positions in the identified straddle. Ideally, the methodology for allocating such losses (where there is no straddle-period gain in remaining identified straddle positions) would be consistent with the method for allocating such losses when there is some (but not "enough") straddle-period gain in the remaining positions, so that the entire methodology for allocation of losses does not depend on whether or not there is a dollar of gain on an offsetting position. One possible approach would be to provide that losses be allocated first in proportion to straddle-period gains in remaining identified positions to the extent thereof, and then in proportion to the respective fair market values of those positions, unless the Secretary provides for a different method of allocation.[8]

2. *Offsetting Positions that Are Liabilities*

In addition, the language of the Act does not address the treatment of a recognized loss on a position in an identified straddle when there is unrecognized straddle-period gain with respect to another position that is a *liability* (and thus as a technical matter cannot have "basis"). For instance, suppose that a taxpayer identifies a straddle consisting of stock the basis of which is $100 and a written call option on the stock (that is not a qualified covered call) for which the taxpayer has received a premium of $20. The taxpayer subsequently sells the stock for $85, realizing a loss of $15, at a time when the fair market value of the taxpayer's liability under the option is $9 (*i.e.,* there is built-in gain of $11 on the taxpayer's position with respect to the written call). We think the $15 loss should be allocated to the taxpayer's position on the written call and taken into account under principles comparable to those described above. To the extent that the loss is capitalized into the written call, it would be taken into account when gain or loss is recognized on the written call.[9]

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[7] As a matter of tax policy, any straddle-period loss that exceeds the aggregate unrecognized straddle-period gains in (appropriately identified) offsetting positions arguably should be currently deductible rather than subjected to capitalization (or deferral). However, this observation would require careful consideration of what is (or should be) meant by "offsetting positions." Moreover, taxpayers whose straddle-period losses exceed straddle-period gains may be able to resort to self-help by simply selling their remaining identified straddle positions.

[8] See our proposed changes to Section 1092(a)(2)(A)(ii) and (iii) in the Appendix, which are intended to effect this result.

[9] See the parenthetical in our proposed Section 1092(a)(2)(A)(ii) in the Appendix, which is intended to effect this result.

Assuming that the loss realized on the sale of the stock would be a long-term capital loss and that gain or loss on the written call would be short-term capital gain or loss, this example illustrates a potential

3. Ability to Identify Absent Regulations

We also believe that the language granting authority to the Secretary to write regulations regarding identified straddles should be rephrased to remove any inference that regulations are required in order for taxpayers to identify straddles under Section 1092(a)(2)(B).[10] The Act provides that an "identified straddle" is one:

> (i) that is clearly identified on the taxpayer's records as an identified straddle before the earlier of the close of the day on which the straddle is acquired and any other time prescribed by the Secretary in regulations,
>
> (ii) to the extent provided in regulations, the value of each position of which is not less than the basis thereof in the taxpayer's hands immediately before the creation of the straddle, and
>
> (iii) which is not part of a larger straddle.[11]

The flush language of Section 1092(a)(2)(B), however, provides that "[t]he Secretary *shall* prescribe regulations which specify the proper methods for clearly identifying a straddle as an identified straddle . . . ." We understand that there may be a view that this language implies that there are no proper methods of identifying an identified straddle until the Secretary so prescribes them. We do not believe that this reading of the provision is correct as a literal matter or appropriate as a matter of tax policy.[12] Pending the issuance of guidance by the Secretary (perhaps in the form of a revenue procedure), it should be sufficient that the taxpayer timely and clearly identifies the identified straddle and preserves the identification as part of its records (as is currently the case in a number of regimes under the Code and Regulations[13]).

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consequence of the Identification Amendment that Congress may not have been fully aware of, namely the potential for the holding period of gain or loss to be transformed through capitalization, absent a rule that requires that the holding period of the capitalized loss be preserved by accounting for it separately. Similar issues arise with respect to the character (ordinary or capital) of capitalized losses.

[10] See our proposed Section 1092(a)(2)(C) in the Appendix.

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

[12] Again, particularly in light of the current applicability of the physical settlement rule, discussed below, it is essential that taxpayers have a clear ability to elect to avail themselves of the identified straddle rules so as to avoid uneconomic and potentially severe consequences.

[13] *See, e.g.,* Treas. Reg. Section 1.1275-6(e) (election to integrate indebtedness and qualifying hedge); Treas. Reg. Section 1.988-3(b)(3) (election out of Section 988 for certain derivatives); Section 475(b)(2) (election out of the mark-to-market regime for certain clearly identified securities or hedges); Treas. Reg. Section 1.1012-1(c)(3) (identification of stock sold made by specifying stock to broker and receiving written confirmation thereof within a reasonable time thereafter).

4. Identification in the Case of "Simple Matching"

We also think it should be made clear in the legislative history to this amendment that the Secretary's authority to write regulations with respect to identified straddles should be used to further the purpose of the Identification Amendment, and that the legislative history should provide examples to guide taxpayers until regulations are issued and to ensure that regulations address the unbalanced straddle problem in a practical and economically appropriate manner. Assume, for instance, that a taxpayer owns 300 shares of common stock GHI (and has no positions with respect to stock GHI other than those described). At a time when the value of the stock is $100/share, the taxpayer buys a put option with a term of three years to sell 100 shares of stock GHI for $95 a share (the "strike price"). The taxpayer should be permitted to identify the put option with 100 shares of stock GHI.[14]

While we think this result is both perfectly appropriate and clearly intended, as reflected in the legislative history, we understand that neither the appropriateness of the result nor the intent of Congress may be entirely clear to IRS and Treasury personnel. In particular, we understand that Treasury and the IRS may have some concern that the put option described in the preceding paragraph may economically "hedge" more than 100 shares of the stock held by the taxpayer. The consequence of this reasoning would be that if the taxpayer identifies only 100 shares with the 100 puts, s/he may have invalidly identified the straddle because the put option is "part of a larger straddle" (with the unidentified 200 shares) within the meaning of Section 1092(a)(2)(B)(iii).[15] Thus, the taxpayer would be left with an "unbalanced straddle" problem similar to that described in note 3, above. Again, in the absence of regulatory authority to "fix" the unbalanced straddle problem, and in light of the potentially harsh consequences of the Physical Settlement Rule for taxpayers with unbalanced straddles who have not "properly identified" the positions of an identified straddle,[16] we think it essential that there be clarity with regard, at least, to the simple cases of what constitutes an identified straddle.

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[14] *See* JCT, *supra* note 2.

[15] It could also be argued that because the "delta" of the puts in this example is less than one (*i.e.,* the value of a put changes by less than $1 for each $1 change in the value of a share), *fewer* than 100 shares should be identified with the 100 puts. Such an approach to identification, in addition to being inconsistent with the legislative history of the Amendment (*see* JCT, *supra* note 2, suggesting that 50 shares and 50 puts are an appropriate identified straddle, notwithstanding that a put has a delta of less than 1 with respect to the corresponding share), would have both practical and administrative difficulties – the delta of a derivative instrument with respect to its underlying asset changes constantly, with the result that a "delta" approach to identification would require constant reassessment of what positions are (or should be) part of the identified straddle at any given time.

[16] *See* note 3, above.

B. Issues for Further Consideration and/or Guidance in Legislative History

1. Larger Straddle: Dynamic Hedging and Overhedging

We think that it would be helpful if the legislative history were to make clear how the requirement that an identified straddle not be part of a "larger straddle" is intended to operate when a taxpayer "overhedges," or engages in a pattern of "dynamic hedging." Suppose, for instance, that a taxpayer who owns 300 shares of common stock of JKL corporation identifies the JKL stock and 300 written call options (not qualified covered call options) as an identified straddle, but at the same time or thereafter writes 150 additional call options that operate further to reduce the risk of loss on the 300 shares of JKL stock in the purported identified straddle,[17] that cannot be properly identified with other "unidentified" positions (because the taxpayer owns only 300 shares of JKL), and that the taxpayer does not identify with the 300 shares and the original 300 options. There is a fundamental question whether the purported identified straddle is appropriately viewed in such a case as part of a larger straddle. A great deal could be said about either side of this argument, on the grounds of tax policy, finance theory, complexity and administrative burden, and we believe that further consideration is needed of the issue.[18]

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[17] As in the case of the put options described in note 15, the "delta" of a written call option with respect to the underlying asset is less than one. Thus, any 300 written calls (with a strike price higher than zero) at any moment in time "perfectly" hedge less than 300 shares. Overhedging (in this case, writing call options on more shares than the taxpayer owns, so that the "delta" of the options with respect to the shares is in the first instance closer to one), or dynamic hedging (constantly writing or unwinding written calls so that the aggregate call position has a delta of one with respect to the taxpayer's 300 shares at any time), therefore can allow a taxpayer to maintain a "better hedge," economically, of 300 shares than simply writing 300 calls. Again, as in the case of the put options, the number of written calls that are needed to "perfectly hedge" a stock position at a given time is very unlikely to be a perfect hedge of that stock position at any other time, so that treating all such call positions as part of a straddle with the stock position (at least absent such constant adjustments by the taxpayer) is of debatable merit over time. *Compare* Rev. Rul. 80-238, 1980-2 C.B. 96 (out of the money option to sell does not preclude dividends received deduction under Section 246 because, "[t]he writing of call options . . . affords the writer no protection against loss, beyond the option price received. . . . [T]he writing of these options does not place the writer in a risk-free position . . . ."). For instance, as the stock's value increases, if the taxpayer does not unwind its written calls appropriately, the "additional" calls will cease to act as a hedge of the taxpayer's stock position (and *vice versa*). In effect, the additional premium received for the additional calls protects the taxpayer against this risk.

[18] Note that "overhedging" and "dynamic hedging" are distinguishable from the case where a taxpayer that owns 300 shares of MNO stock initially identifies 100 shares as a straddle with 100 purchased puts on MNO stock, and on two subsequent occasions purchases 100 puts on MNO stock, each of which is identified with another 100 shares of MNO stock. In the latter case, there is no "larger straddle" abuse potential because each purchase of 100 put options on MNO stock does reduce the risk of loss on the 100 shares of stock with which it is identified at least as much as it reduces the risk of loss on MNO stock that is part of another identified straddle. We do think that the issue would be raised where on the same facts the taxpayer attempted to identify the subsequent puts with the same 100 MNO shares that were identified as part of the original identified straddle; this also raises the chronological identification issues discussed below.

2. Larger Straddle: Interaction with Section 1092(c)(2)(B)

Note a technical but important ambiguity relating to the issue addressed in the preceding discussion: Under Section 1092(c)(2)(B), a position that is not part of an identified straddle is not treated as offsetting with respect to any position that is part of an identified straddle. Thus, while it is simple enough, if one chooses to do so, to require a taxpayer who owns 300 shares to identify 450 written calls with those shares when they are written at the same time (on the ground that they are then "part of a larger straddle"), Section 1092(c)(2)(B) may be read to preclude such an identification where the "additional" 150 calls are written after the original 300 have been written and identified.

Without regard to one's views as to the appropriate treatment of 300 shares and 450 calls under the Identification Amendment, this chronological tension between the "larger straddle" prohibition on identification and the identified straddle exception to the offsetting position rule can lead to clearly inappropriate results. For example, in Revenue Ruling 2002-66, 2002 C.B. 812, the Service concluded that where a taxpayer holding stock and a put subsequently writes a qualified covered call option, the call is not excluded from straddle treatment because it is "part of a larger straddle" within the meaning of Section 1092(c)(4)(A)(ii). Presumably, the same result should obtain under the Identification Amendment; however, if the taxpayer in the Ruling had identified the stock and put before writing the call, Section 1092(c)(2)(B) might be read to preclude this result. We think the taxpayer in this case should be required to identify the subsequently written call as part of the identified straddle initially consisting of the stock and put (rather than, for example, "losing" the status of the existing identified stock-put straddle as an identified straddle); thus, we think it would be helpful if legislative history were to specify that this result is intended notwithstanding Section 1092(c)(2)(B)).

3. Chronological Identification and Loss Positions

The preceding discussion assumes that the concept of identifying the positions of an identified straddle can in the first instance have a chronological aspect to it, which is not entirely clear from the Amendment as drafted.[19] We think that a taxpayer should be able (and, as discussed above, should in some cases be required) to add newly acquired

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[19] Imagine, as above, a taxpayer who identifies 100 shares of PQR stock and 100 put options to sell PQR stock. If the taxpayer thereafter writes 100 call options to sell PQR stock, s/he should be permitted (indeed, if s/he has no other PQR shares or other potential offsetting positions to the written calls, required) to identify the calls as part of the pre-existing stock-put straddle. The technical ambiguity here is whether this straddle is "clearly identified . . . before . . . the close of the day on which the straddle is acquired." Section 1092(a)(2)(B)(i)(I). We think it reasonably clear that the relevant straddle – *i.e.,* that consisting of the stock, the put *and* the call – was "acquired" when the call was written, and thus that identification before the close of that day is adequate to identify it as an identified straddle (as well as to preclude any "larger straddle" argument). We have, however, proposed to modify this language slightly to mitigate somewhat any inference that a straddle *position* (as opposed to the straddle itself) cannot be identified as part of an identified straddle after the date the position was acquired.

positions to an existing identified straddle, if such positions otherwise meet the identified straddle criteria. However, the Amendment could be read to disfavor this result where any of the pre-existing identified straddle positions has a built-in loss at the time of the addition of the new position, because it states that to the extent provided in regulations, a straddle cannot be identified if any position composing the straddle has a basis higher than its value at the time of the identification (see Section 1092(a)(2)(B)(ii)).[20] We think it would be helpful if the legislative history were to provide that any regulatory prohibition on identification of loss positions (if any) should except positions that were properly part of a previously identified straddle.

4. *Partial Unwinds of Identified Straddle Positions*

Finally, we note that Congress has given the Secretary authority to "specify the ordering rules in cases where a taxpayer disposes of less than an entire position which is part of an identified straddle." We assume this is intended to address cases where a taxpayer disposes of *gain*, rather than loss, positions, given that the treatment of losses from identified straddle positions is otherwise adequately addressed by the Amendment, even where only a portion of a loss position is disposed of.[21] As we discussed in our 2000 Report, one possibility is to mark the gain and loss positions to market at that time, capitalizing an appropriate amount of the loss so realized into the basis of the offsetting positions (including the disposed-of gain position), and then treating the loss position and any remaining offsetting positions as a new identified straddle. Another alternative would be to permit taxpayers to recognize, at the time of the disposition of an identified gain position, any built-in loss in the loss position to the extent it exceeds the gain recognized on the disposition. Presumably, in the absence of regulatory guidance, taxpayers will be required to address these situations on an *ad hoc* basis as circumstances arise.

II. The Physical Settlement Rule

As a final, technical point, we note that the Physical Settlement Rule as drafted applies only for purposes of Section 1092. This limitation is puzzling and, we think, unnecessary. Read literally, it might support a position that is uneconomically favorable to

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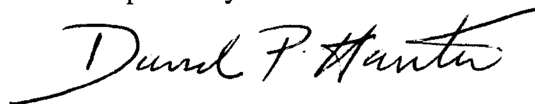
[20] For example, if the taxpayer in note 19 writes the call at a time when the stock has risen relative to the date s/he purchased the put, so that the put consequently has an amount of "built-in loss," the Amendment might be read to prevent the taxpayer from identifying the stock/put/call straddle as an identified straddle.

[21] Note, however, that the Amendment seems to provide that a loss realized on a portion of a straddle position must be capitalized into the basis of all of the remaining identified positions (to the extent they have any built-in gain). As a theoretical matter, this seems inappropriate – the loss should be capitalized into only a *pro rata* portion of the remaining positions. Indeed, this analysis leads to a question whether the position offsetting a one-share put option is in fact a single share, and thus whether a taxpayer should be able to (or should be deemed to, if it has identified 100 shares and 100 puts) identify 100 shares and 100 puts as 100 identified straddles (with the consequence that a loss on the sale of 30 puts would be capitalized into the basis of 30 shares). We think this an appropriate result, although (absent regulations permitting and/or deeming unit-by-unit identification) it is unclear whether unit-by-unit identification is permissible.

taxpayers. For example, imagine that a taxpayer who owns 100 shares of stock STU, each with a value of $100 and a basis of $0, writes a covered call option that is not a "qualified covered call" to sell 100 shares of STU stock at a specified future date for a "strike price" of $100 each, in exchange for a premium of $2,000. Assume the taxpayer identifies the shares and the option as an identified straddle. Now suppose that at the maturity of the option, the STU stock is worth $160 per share, and the taxpayer delivers 100 shares in exchange for $10,000 pursuant to the option. Absent the application of the Physical Settlement Rule, the taxpayer would be treated as having sold her 100 shares for $12,000 (the $10,000 strike price plus the $2,000 premium). However, under the Physical Settlement Rule, the taxpayer is treated as realizing a $4,000 loss on the settlement of the option ($6,000 "settlement value" minus of $2,000 of premium received) and selling her shares for their fair market value, $16,000, resulting in a "net" recognized gain of $12,000. However, literally, the taxpayer is treated as having sold the shares for $16,000 *only for purposes of Section 1092* – for all other purposes, including the recognition of gain on disposition of the shares under Section 1001, she is treated as having sold the shares for the strike price plus the premium she received, or $12,000, resulting in a recognized gain of $8,000 (after taking account of her $4,000 capitalized basis).[22] We are confident that this was not the intended reading of the Physical Settlement Rule, but we think clarification is warranted.[23]

Respectfully submitted,



David P. Hariton
Chair

cc: Mr. Kolan Davis
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[22] It might be argued that if Section 1092 were not read to affect the amount the taxpayer realizes for purposes other than Section 1092, then it also should not be read to affect the taxpayer's basis in the stock for purposes other than Section 1092 (*e.g.*, Section 1012). However, Section 1092 itself clearly does increase the taxpayer's basis in the stock (for all purposes), whereas nothing in Section 1092 governs the amount a taxpayer realizes under the Code.

[23] *Cf.* Section 1256(c)(1) and Treas. Reg. Section 1.988-2(a)(2)(ii)(B), which use similar language, and which we do not believe have been understood to have the limited effect suggested in the text.

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Appendix – Proposed Amendments to Section 1092(a)

(2) SPECIAL RULE FOR IDENTIFIED STRADDLES.—

(A) IN GENERAL.—In the case of any straddle which is an identified straddle—

(i) paragraph (1) shall not apply with respect to identified positions comprising the identified straddle,

~~(ii) if there is any loss with respect to any identified position of the identified straddle, the basis of each of the identified offsetting positions in the identified straddle shall be increased by an amount which bears the same ratio to the loss as the unrecognized gain with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all such offsetting positions, and~~

(ii) if a loss is realized with respect to any position in the identified straddle, such loss shall be allocated to the offsetting positions in such identified straddle first in proportion to their respective unrecognized gain, if any, to the extent thereof, and then in proportion to the respective fair market values of such offsetting positions, or in such other manner as the Secretary may prescribe, as an addition to the basis of such other positions (or in a similar manner in the case of positions that constitute liabilities), and

(iii) any loss ~~described in~~**allocated pursuant to** clause (ii) shall ~~not otherwise~~ be taken into account for purposes of this title **only in a manner consistent with such allocation and the purposes of this section**.

(B) IDENTIFIED STRADDLE.—The term "identified straddle" means any straddle—

(i) which is clearly identified on the taxpayer's records as an identified straddle ~~before the earlier of—~~

(I) **before** the close of the day on which the straddle is ~~acquired~~**entered into**, or

(II) **at** such **other** time as the Secretary may prescribe by regulations~~.~~**, and**

(ii) to the extent provided by regulations, the value of each position of which (in the hands of the taxpayer immediately before the creation of the straddle) is not less than the basis of such position in the hands of the taxpayer at the time the straddle is created, and

(iii) which is not part of a larger straddle.

C) REGULATIONS.— The Secretary shall prescribe **such regulations** ~~which~~ **as may be necessary or appropriate to carry out the purposes of this paragraph. To the extent provided in regulations, the Secretary may specify** ~~the proper~~ methods for clearly identifying a straddle as an identified straddle (and the positions comprising such straddle), which specify the rules for the application of this section for a taxpayer which fails to properly identify the positions of an identified straddle, and which specify the ordering rules in cases where a taxpayer disposes of less than an entire position which is part of an identified straddle.

(3) UNRECOGNIZED GAIN.—For purposes of this subsection—

(A) IN GENERAL.—The term "unrecognized gain" means—

(i) in the case of any position held by the taxpayer as of the close of the taxable year, the amount of gain which would be taken into account with respect to such position if such position were sold on the last business day of such taxable year at its fair market value, and

(ii) in the case of any position with respect to which, as of the close of the taxable year, gain has been realized but not recognized, the amount of gain so realized.

(B) SPECIAL RULE FOR IDENTIFIED STRADDLES.—For purposes of paragraph (2)(A)(ii), the unrecognized gain with respect to any identified offsetting position shall be the excess of the fair market value of the position at the time of the determination over the fair market value of the position at the time the taxpayer identified the position as a position in an identified straddle.

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(8) SPECIAL RULES FOR PHYSICALLY SETTLED POSITIONS.— ~~For purposes of subsection (a), if~~**If** a taxpayer settles a position which is part of a straddle by delivering property to which the position relates (and such position, if terminated, would result in a realization of loss), then such taxpayer shall be treated as if such taxpayer—

(A) terminated the position for its fair market value immediately before the settlement, and

(B) sold the property so delivered by the taxpayer at its fair market value