REPORT #750

TAX SECTION

New York State Bar Association

Report on Regulations To Be Issued Under Section 246(c)
Restricting the Dividends Received Deduction

by The New York State Bar Association
Tax Section Corporations Committee

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TAX SECTION
New York State Bar Association

February 23, 1993

Michael P. Dolan
Acting Commissioner
Internal Revenue Service
1111 Constitution Ave. NW
Washington, DC 20224

Dear Commissioner Dolan:

Enclosed is a report of our Corporations Committee, drafted by Richard L. Reinhold and Robert H. Scarborough, which responds to the Service's request for assistance in the preparation of regulations under 246(c) of the Internal Revenue Code. That Section imposes limitations on the dividends received deduction for corporate shareholders, which were made substantially more stringent in 1984.

The 1984 Act incorporated a number of new concepts, which have not yet been explicated by regulations. The enclosed report comments on some of these concepts. It suggests an approach pursuant to which the "substantially similar or related property" standard incorporated in Section 246(c) should be delineated through a series of examples in regulations, with such examples to be supplemented by subsequent revenue rulings where necessary. It also proposes that regulations applying this standard apply only prospectively except for the transactions enumerated in the legislative history of the 1984 Act.

The enclosed report also deals with certain issues which existed under Section 246(c) even prior to the 1984 Act. These include the status of mandatorily redeemable stock, preferred stock puttable to the issuer, and preferred stock puttable to a third party where the put strike price is not set for at least 46 days following purchase of the stock.

Finally, the report suggests rules to deal with the writing of call options by a corporate shareholder which are not “qualified covered call” options dealt with in Section 246(c)(4) of the Code, and the treatment of equity swap transactions. The report takes the position that a corporate holder which is on the short side of an equity swap transaction may be considered to have undertaken an obligation to make related payments within the meaning of Section 246(c)(1)(B) of the Code. It also concludes that a corporate holder who is short an equity swap could also be considered to have diminished his risk of loss by holding positions with respect to substantially similar or related property within the meaning of Section 246(c)(4)(C) of the Code, but in this case only through regulations which would be prospective in effect.

We hope you find the enclosed report to be of assistance. We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

Peter C. Canellos
Chair

Enclosure

PCC: cig

cc: Mr. James Fields
Acting Assistant Secretary and
Deputy Assistant Secretary
Treasury Department
1500 Pennsylvania Avenue N.W.
Washington, DC 20220

Ms. Judith Dunn
Deputy Tax Legislative Counsel
for Regulatory Affairs
Treasury Department
1500 Pennsylvania Avenue N.W.
Washington, DC 20220

Mr. Andrew Dubroff
Associate Tax Legislative Counsel
Treasury Department
1500 Pennsylvania Avenue N.W.
Washington, DC 20220

Mr. Joseph Doloboff
Attorney Advisor
Treasury Department
1500 Pennsylvania Avenue N.W.
Washington, DC 20220

Mr. David Weisbach
Attorney Advisor
Treasury Department
1500 Pennsylvania Avenue N.W.
Washington, DC 20220

Mr. Sam Sessions
Treasury Department
1500 Pennsylvania Avenue N.W.
Washington, DC 20220

Mr. Maurice Foley
Treasury Department
1500 Pennsylvania Avenue N.W.
Washington, DC 20220

cc: Mr. Michael P. Dolan
Acting Commissioner
Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224

Mr. David Jordan
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Ave. NW
Washington, DC 20224

Mr. Stuart L. Brown
Associate Chief Counsel (Domestic)
Internal Revenue Service
1111 Constitution Ave. NW
Washington, DC 20224

Ms. Mary L. Harmon
Internal Revenue Service
1111 Constitution Ave. NW
Washington, DC 20224

Mr. Thomas R. Hood
Internal Revenue Service
1111 Constitution Ave. NW
Washington, DC 20224

Mr. James F. Malloy
Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224

Mr. William E. Coppersmith
Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224

Robert N. Deitz (Branch 2)
Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224

Mr. Richard G. Larkins
Internal Revenue Service
1111 Constitution Ave.,
NW Washington, DC 20224

Report on Regulations To Be Issued Under Section 246(c) Restricting the Dividends Received Deduction

by The New York State Bar Association
Tax Section Corporations Committee[1]

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I. INTRODUCTION

The purpose of this report is to suggest approaches that might be taken in regulations implementing the restrictions on the dividends received deduction ("DRD") contained in section 246(c).[2] The report responds to the request of the Internal Revenue Service for assistance in the preparation of such regulations.

Section 246(c), which was enacted in 1958 and significantly amended in 1984, generally denies the DRD in two circumstances:

First, the DRD is denied to the extent that the tax-payer is under an obligation to make related payments with respect to positions in substantially similar or related property ("SSRP"). Thus, for example, where the taxpayer is simultaneously long and short the same stock, and makes a deductible "in lieu

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[1] This report was drafted by Richard L. Reinhold and Robert H. Scarborough. Assistance in preparation of the report was provided by Reuven Avi-Yonah, Dickson Brown, Peter C. Canellos, John A. Corry, Charles M. Morgan III, Dennis Ross, Michael L. Schler and Ralph O. Winger.

[2] "Section" references herein are to the Internal Revenue Code of 1986, as amended; references to "Treas. Reg. § ____" are to treasury regulations promulgated there-under.

of” payment on the short position, the taxpayer is not allowed the DRD for the dividend received on the long position. See section 246(c)(1)(B).

Second, the DRD is denied unless the taxpayer has held the stock for at least 46 days. See section 246(c)(1)(A). For this purpose, the holding period is reduced for any period during which the taxpayer is protected against loss in certain specified ways. The holding period is reduced for any time period during which the taxpayer has an option to sell (i.e., a put), is under a contractual obligation to sell or has made and not closed a short sale of substantially identical stock or securities (“SISS”), is the grantor of an option to buy SISS, or, under regulations, has diminished the risk of loss by holding one or more other positions with respect to SSRP. See section 246(c)(4).

This report considers a number of issues that arise in applying these rules, including the following:

(1) The SSRP standard. In what circumstances should a taxpayer be considered to have diminished the risk of loss by holding a position with respect to SSRP within the meaning of section 246(c)(4)(C)?

(2) The treatment of mandatorily redeemable preferred stock. Does the required redemption represent a contract to sell within the meaning of section 246(c)(4)(A)?

(3) Preferred stock that is puttable to a third party but the put is not exercisable--and the strike price is not set—for 46 days after the purchase. Is the put an option to sell subject to section 246(c)(4)(A)?

(4) Preferred stock puttable to the issuer. Is the put an option to sell subject to section 246(c)(4)(A)?

(5) The treatment of short call options that are not “qualified covered call options.” The rule tolling the DRD holding period where the taxpayer has granted a call option does not apply where the option is a qualified covered call option. Does the granting of any other type of option toll the holding period?

(6) The treatment of equity swap transactions. What if the swap includes an obligation to pay amounts equal to dividends paid on the stock, amounts based on last year's dividends, or a dividend equivalent amount subject to a cap and floor? Is a deduction for such amounts denied under section 246(c)(1)(B)?

Part II of this report is an overview that discusses both the policy reasons for restricting the DRD and the history and development of current law restrictions. Part III summarizes our recommendations as to how Treasury and the Ser-vice should respond to the issues considered in this report. Part IV is a more detailed discussion of our recommendations.

II. OVERVIEW AND BACKGROUND

Although income earned through investments in corporate equity is subject to double taxation, Congress has, since the beginning of the corporate income tax, allowed corporations a DRD to prevent multiple taxation of the same income within the corporate sector.[3] Currently, section 243 allows a DRD of from 70 percent to 100 percent, depending on the percentage of the stock of the distributing corporation owned by the recipient.

1. 1958 Act

Congress enacted section 246(c) in 1958 to address the following two transactions, which are described in the legislative history:

> (1) A corporation buys stock just before a dividend is payable with the intention of receiving dividend income and then, immediately after the dividend is payable, selling the stock. Prior to the enactment of section 246(c), only 15% of the dividend was taxable to the corporation, but the corporation recognized a loss in approximately the amount of the dividend.[4]
>
> (2) A corporation is in both a long and short position over the dividend date. Prior to the enactment of section 246(c), the dividend received was eligible for the DRD, and the payment to cover dividends in the short position was deductible.[5]

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[3] See Statement of O. Donaldson Chapoton, Assistant Secretary (Tax Policy), Department of the Treasury, Before the Committee on Finance, United States Senate 5 (July 13, 1988).

[4] See H.R. Rep. No. 775, 85th Cong. 1st Sess. (1957), 1958-3 C. B. 811, 824.

[5] See id.

Section 246(c), as originally enacted, contained two rules, each of which addresses one of these transactions:

Section 246(c)(1)(A) provided a 16-day DRD holding period (91 days for certain preference dividends relating to periods over one year), and section 246(c)(3) provided for tolling the holding period for periods in which “the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of substantially identical stock or securities.” These rules limit the opportunities for purely tax-motivated transactions around the ex-dividend date by insisting that the taxpayer accept a minimum amount of market risk in order to obtain the DRD.

Section 246(c)(1)(B) denied the DRD “to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make corresponding payments with respect to substantially identical stock or securities.” This rule curtails arbitrage through simultaneous long and short positions in stock.

2. 1984 Act

a. House Bill Approach

Congress amended section 246(c) in 1984 out of concern that dividend stripping transactions employing modern hedging techniques were circumventing those limitations. The House bill (H.R. 4170) thus contained a provision substituting a functional risk reduction standard, borrowed from the straddle rules of section 1092,[6] for the transaction-oriented restrictions then

[6] Section 1092(c)(1) defines “straddle” as “offsetting positions with respect to personal property.” Section 1092(c)(2) provides that a “taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss

contained in section 246(c)(3). Under this standard, the DRD holding period would be tolled during any period in which the taxpayer holds one or more other positions that substantially diminish the risk of loss from holding the stock. This standard was originally recommended in the Administration's fiscal year 1985 budget proposals.[7]

The legislative history expressed concern that both the anti-arbitrage rule of section 246(c)(1)(B) and the risk reduction rule of section 246(c)(1)(A) were inadequate. The Report stated that

> [S]ome corporations are engaging in straddle like transactions by buying a dividend paying stock and selling short similar securities (like convertible bonds). If the property sold short is not substantially identical, the dividends received deduction can be claimed [and] the short sale expenses deducted in full against ordinary income.[8]

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from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind)."

7 Department of the Treasury, Revenue Proposals Contained in the Administration's Fiscal Year 1985 Budget, General Explanations, reprinted in Tax Notes document 84-1320, February 17, 1984.

8 H.R. Rep. No. 432, 98th Cong. 2d Sess. 1185-86 (1984); S. Prt. No. 169, 98th Cong. 2d Sess. 1-172 (1984).

The legislative history also stated that the risk reduction rules "are not comprehensive, and the Committee believes they should be tightened."[9]

Industry reaction to the proposals was strong:

[T]he [Securities Industry Association] believes that the "substantially diminished" risk of loss is too vague a standard to be adopted without causing severe dislocations and disruptions in the equity markets because of its uncertainty of application. . . . For example, would a taxpayer that is short one utility stock and long the stock of another utility be considered to have substantially diminished its risk of loss?[10]

b. Senate Bill Approach

As a compromise between the House bill and the law then in effect, the Senate amendment would have tolled the DRD holding period where, under regulations, the taxpayer has otherwise reduced the risk of loss from holding the stock by reason of holding one or more positions in substantially similar property. The Senate Report provided that the concept of "substantially similar property" was to be broader than the concept of "substantially identical stock or securities," but not as broad as the concept of "offsetting positions" in section 1092.[11]

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[9] H.R. Rep. No. 432, 98th Cong. 2d Sess. 1186 (1984); S. Prt. No. 169, 98th Cong. 2d Sess. 1-172 (1984).

[10] Statement of M. Bernard Aidinoff, on Behalf of Securities Industry Association, reprinted in "Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms," Hearings Before the Committee on Ways and Means, House of Representatives, 98th Cong., 2d Sess. 167, 170 (1984).

[11] S. Prt. 169, 98th Cong. 2d Sess. 1-173-74 (1984).

c. Final Bill

The final bill enacted by Congress adopted a risk reduction standard similar to the standard in the Senate amendment. The DRD holding period is tolled where, "under regulations prescribed by the Secretary, a taxpayer has diminished his risk of loss by holding one or more positions with respect to substantially similar or related property" (the "SSRP Standard"). In addition, the final bill (i) replaced the SISS standard in section 246(c)(1)(B) (related payments provision) with the new SSRP Standard, (ii) lengthened the DRD holding period from 16 to 46 days, and (iii) added a rule, reflected in section 246(c)(4)(B), providing for tolling the DRD holding period where "the taxpayer is the grantor of an option to buy [SISS]".

d. Transactions Identified as Subject to SSRP Standard

The Conference Report identified the following two types of transactions as being within the scope of the SSRP Standard from the date of enactment of the bill (hereafter "Target Transactions"):[12] (1) a short sale of common stock when the taxpayer holds convertible preferred stock of the same issuer and the price changes of the convertible preferred stock and the

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12 H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 818 (1984); see also Wetzler, "The Tax Treatment of Securities Transactions Under The Tax Reform Act of 1984," 25 Tax Notes 453, 467-68 (1984).

common stock are related[13] and (2) the acquisition of a short position in a regulated futures contract ("RFC") on a stock index[14] while holding the stock of an investment company whose principal holdings mimic the performance of the stocks included in the stock index.[15] The Conference Report provided that the regulations are to apply to other transactions only on a prospective basis.

The Conference Report also provided that the DRD holding period is not to be tolled merely because the taxpayer is hedged against*general market risks, through, for example, an option on a stock index. In addition, common stock in one corporation is not ordinarily to be viewed as substantially similar or related to common stock of another corporation. Where stocks of similar companies are involved, however, a short sale of preferred stock of one corporation while holding preferred stock of the other corporation may result in tolling the DRD holding period.

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13 The Conference Report states that the same result is to obtain in the case of a short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible or common stock, or a short sale of convertible preferred stock while holding common stock.

14 The Conference Report states that the same treatment is to apply to the acquisition of an option to sell the RFC or the stock index itself, or the grant of a deep in-the- money option to buy the RFC or the stock index.

15 The Conference Report states that the same treatment is to apply in the case of a portfolio composed of stocks that mimic the performance of the stocks included in the stock index.

III. SUMMARY OF RECOMMENDATIONS

A. Scope of SSRP Standard

We recommend that regulations delineate the scope of the SSRP Standard through a series of examples of transactions that will and will not be considered to involve the reduction of risk through holding substantially similar or related property. The Commissioner might be given the authority to expand, by revenue ruling, the set of such transactions. Regulations should not attempt to define the SSRP Standard through a mathematical formula that weighs the degree to which the taxpayer has hedged risk.

Regulations should confirm that the SSRP Standard applies to Target Transactions defined in the legislative history as of July 18, 1984, the effective date of the 1984 Act, but that the standard does not apply to other transactions until after the date that regulations are finalized. We recommend that regulations adopt the same effective date for the SSRP Standard in section 246(c)(1)(B) (related payments rule) as for the SSRP Standard in section 246(c)(4)(C) (tolling of the DRD holding period).

Regulations should address the question of whether a taxpayer who is long a basket of preferred stocks and short an offsetting basket of preferred stocks has met the SSRP Standard in section 246(c)(4)(C) and section 246(c)(1)(B). Although we have some question as to whether these transactions are properly brought within the SSRP Standard, on balance we conclude that the transactions should be so included. However, we believe that the standard should be considered met in this case only on a prospective basis, unless the corporations issuing the stocks in the two baskets are in the same or similar industries.

B. Other Issues

1. Mandatorily Redeemable Preferred Stock

Preferred stock that is mandatorily redeemable should not be considered subject to a contract to sell within the meaning of section 246(c)(4)(A).

2. Puttable Preferred Stock

If preferred stock is puttable to a third party, but the strike price at which the stock is puttable is not fixed for more than 45 days after acquisition of the stock, the stock should not be subject to section 246(c)(4).

The regulations should address the question whether preferred stock that is puttable only to the issuer can ever be subject to section 246(c); the report notes that there is a sound basis for concluding that such arrangements should not be within the scope of section 246(c).

3. Short Call Options

Granting of a call option that is not a “qualified covered call option” should not toll the DRD holding period unless the granting of the option materially diminishes the taxpayer's risk of loss.

4. Payments Under Equity Swap Contracts

If an equity swap transaction provides for payments equal to the dividends paid on the underlying stock during the term of the contract, the regulations should confirm that the party obligated to make such payments is not entitled to the dividends received deduction by reason of the related payments rule of section 246(c)(1)(B). Where the dividend equivalent payment on the swap is linked to a prior year's dividends on the stock, or to current dividends actually payable, but subject to a cap and/or floor, resolution of the question of whether the payments are related should be on a case-by-case basis.

If equity swap payments are linked to the diminution in value of the equity, the party entitled to receive the payments is protected against loss. Thus, regulations under section 246(c)(4)(C) should toll the DRD holding period.

IV. DISCUSSION OF RECOMMENDATIONS

A. SSRP Standard

1. Scope

We believe that it would be a mistake to attempt to apply the SSRP Standard using a mathematical or formulaic approach. The standard should not be interpreted as covering all cases in which a taxpayer that holds stock also holds, somewhere in its portfolio, one or more other positions that result in a diminished--perhaps substantially diminished--risk of loss with respect to the long position.

An approach that focuses only on the presence of risk reduction would be inconsistent with the statutory language, which requires that the taxpayer have diminished its risk of loss through a position in “substantially similar or related property.” If any property that diminishes the taxpayer’s risk of loss were considered to be “substantially similar or related”, these words would be surplusage. Such an approach would also be inconsistent with the history of the 1984 Act, in which Congress rejected an “offsetting position” approach.

Furthermore, such an approach would raise serious problems of administration. If applied consistently, it would require the Service (and taxpayers) to employ statisticians to examine all positions in a portfolio, computing co-variances between each stock investment held by the taxpayer and all possible combinations of other positions held by the taxpayer.

As an alternative, we recommend that regulations pro-vide examples of transactions that will and will not be within the scope of the SSRP Standard. We suggest the following examples of transactions (in addition to the Target Transactions) that should be within the scope of the standard: (1) long one series of preferred stock and short another series of preferred stock of the same issuer (significant differences in dividend rate, for example, would prevent such stock from constituting SISS) and (2) while less clear, offsetting long and short baskets of preferred stocks. The Regulations should also give the Commissioner the authority to designate by revenue ruling other transactions that are within the scope of the SSRP Standard.[16]

[16] For a recent example of another grant to the Commissioner of the authority to use revenue rulings to add to a list in a regulation, see Prop. Reg. section 1.446-3(c)(2) (list of specified indices in notional principal contract regulation).

We think strong arguments can be made that offsetting baskets of preferred stock are not within the scope of the SSRP Standard.[17] To the extent that the baskets are large, and each contains a diversified portfolio of many stocks, or that the baskets are small, but represent the stock of issuers in different industries, the taxpayer arguably is using the offsetting baskets to hedge general market risk. The legislative history is clear that the SSRP Standard is not met merely because the taxpayer holds other property that hedges general market risk.[18]

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[17] The Service concluded that this transaction was within the scope of the rule in a recent technical advice memorandum. L.R. 9128050 (April 4, 1991). The TAM involved preferred stocks of different issuers, with the long and short baskets comprised of stocks issued by companies in different industry groupings. Each basket of stocks was sold, in the case of the long positions, or closed out in the case of the shorts, immediately after the 16- or 46-day DRD holding period had run. In general, the taxpayers derived dividend income and capital loss (generally equal to half the dividend amount) on the long positions; and equivalent in-lieu expense and capital gain on the shorts; with price fluctuations hedged through the offsetting positions. The TAM held, inter alia, that the DRD was not allowed for dividends received equal to the in-lieu payments under section 246(c)(1)(B) both as in effect prior to 1984, and as in effect thereafter. Thus, the TAM held that the preferred stocks represented SISS (as to pre-1984 transactions) and SSRP (as to later transactions). In addition, the TAM (i) reduced the DRD claimed by the taxpayer under the alternative grounds that the long stock represented debt-financed portfolio stock subject to section 246A; (ii) denied deductions for the in-lieu expense on the basis that the short sale transactions lacked economic substance; and (iii) denied deductions for the in-lieu expense under the capitalization rule of section 263(h).

[18] H.R. Rep. No. 861, 98th Cong. 2d Sess. 818-19 (1984).

On the other hand, it seems likely that the hedge formed between offsetting baskets of preferred stocks can eliminate most practical risk of holding the long stocks. Moreover, the Conference Report contains a suggestion that the SSRP Standard may be met where the taxpayer is long and short preferred stocks "of similar companies."[19] It is our impression that creditworthiness of issuers plays a much greater role in determining the effectiveness of a hedge than the degree to which the issuers engage in similar business activities. Nonetheless, the legislative history may be read as suggesting that the offsetting basket of preferred stocks strategy is properly brought within the SSRP Standard.

One example of a transaction that generally should not be within the scope of the SSRP Standard is holding stock of one issuer while in a short position in stock of another issuer. As under present law, this exception should not apply where special circumstances cause the price movements of the two stocks to be related, such as by reason of an impending merger between the two issuers.[20]

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19 Id. at 818.

20 See Treas. Reg. §§ 1.246-3(c)(2), 1.1233-1(d)(1).

2. Effective Date of SSRP Standard

Regulations should confirm that the Target Transactions, and no others, are within the scope of the SSRP Standard as of the effective date of the 1984 Act. Other transactions should be considered to fall within the scope of the standard beginning only after regulations are finalized. It is clear from the statute and legislative history that Congress intended prospective application of the SSRP Standard in section 246(c)(4)(C) except as to Target Transact ions.[21]

We recognize that there is no similar explicit mandate for prospective application of the SSRP Standard in section 246(c)(1)(B) (related payment rule) or the related legislative history, and that the statute would appear on its face to be self-executing. Nevertheless, we believe that the effective date of the standard for the two different provisions should be the same. Initially, we think that practical considerations militate in favor of such prospectivity. Investment strategies involving hedged stock positions often will be tested under both section 246(c)(4) (to determine the long position's qualification for the DRD holding period) and section 246(c)(1)(B) (to determine the presence of related payments). Given the identity of the statutory language in both provisions -- the SSRP Standard -- it would seem highly incongruous to afford

[21] The clarity with which the 1984 Act legislature history addressed this effective date issue is fully consistent with the overall approach taken by Congress in amending section 246(c). It is apparent from the legislative record that the compromise SSRP Standard was to apply to Target Transactions, but not more broadly, in order to assuage the concerns expressed by (among others) the Securities Industry Association. See notes 10-12, supra. If the new standard applied to cases other than those specifically identified, “dislocations and disruptions in the equity markets” could well result, given the broad range of risk-reduction strategies adopted by taxpayers to reduce various risks associated with stock ownership and the uncertain scope of the new statutory standard.

relief to the transaction under the holding period rule, only to sanction the precise same transaction under the related payments rule.[22] Moreover, it would seem anomalous to leave unsettled the application of an unformulated standard, while applying that standard only prospectively under a closely related provision.[23] Even if it might have been reasonable to apply the standard under section 246(c)(1)(B) retro-actively but prospectively under section 246(c)(4)(C) had regulations been issued reasonably promptly after the passage of the 1984 Act, that is no longer the case eight years after enactment. Accordingly, we think it appropriate to confine the scope of section 246(c)(1)(B) to transactions involving SISS and Target Transactions, pending issuance of regulations that more broadly define the SSRP Standard.

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[22] This conclusion is underscored by (i) the clear legislative purpose to provide full prospective treatment in section 246(c)(4) as regards the SSRP Standard except as to Target Transactions (see note 21, supra), and (ii) the self-evident virtue, from the point of fairness and administrability of having a single SSRP Standard, applicable in the context of section 246(c)(4)(C) and section 246(c)(1)(B) (as well as sections 263(h)(4)(B) and 1092(d)(3)(B)(i)(II)). It might be argued that Congress contemplated immediate effectiveness for section 246(c)(1)(B) but not section 246(c)(4)(C) on the basis that the requirement of “related payments” would effectively limit the former provision to recognizable transactions. There is no support for such a position in the legislative history, however, and the example given in the testimony of the Securities Industry Association quoted in the text at note 10 above (long stock of one utility and short stock of another utility) indicates that the requirement of related payments would not limit the scope of the provision in any meaningful way.

[23] since the new SSRP Standard was intended to represent a new compromise standard that was more inclusive than SISS (which had been interpreted narrowly to reach only instruments that were virtually identical), but did not involve a functional risk reduction approach, it seems plain that until regulations are issued, the SSRP Standard has no practical meaning apart from its application to Target Transactions.

B. Mandatorily Redeemable Preferred Stock

We recommend that preferred stock that is subject to mandatory redemption at a particular date not be considered as stock that the taxpayer is “under a contractual obligation to sell” within the meaning of section 246(c)(4)(A).[24] There are several reasons for our recommendation. First, mandatorily redeemable preferred stock, generally containing a sinking fund provision, was frequently employed since before 1958, when section 246(c) was added to the Code.[25] it seems highly unlikely that Congress could have intended to deny the DRD for all dividends on such stock. Second, the corporation's obligation to redeem such preferred stock is conditioned on the presence of legally available assets and is not absolute.[26] Third, to the extent that the redemption date is far in the future, the redemption right does not provide the holder significant protection against fluctuations in price during the time that the taxpayer holds the stock.

Finally, the argument can be made that mandatorily redeemable stock is not subject to section 246(c) because the

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24 we use the term “mandatorily redeemable” stock to mean stock that is required to be redeemed by the issuer on a date certain (or multiple fixed dates in the case of sinking fund preferred stock), subject only to the presence of legally available assets. See, e.g., Del. Gen. Corp. Law S 160(a)(1) (corporation may redeem preferred stock only out of capital or surplus).

25 See Dewing, I The Financial Policy of Corporations 152 (1953).

26 See note 24, supra. We recognize the limitation of the rationale stated in the text. While the pre-condition of legally available assets generally is sufficient to result in characterization of an instrument as equity rather than debt, it probably proves too much to say that such condition should in all cases prevent an agreement to sell stock from being treated as a contract to sell within section 246(c)(4)(A). For instance, if a very creditworthy party were willing to write puts whose exercisability was subject to the issuer's having legally available assets, but such condition did not affect the degree of downside risk protection in any material way, it seems reasonable to expect that the put would fall within section 246(c)(4)(A).

redemption feature is an inherent component of the stock itself, rather than a separate position.[27] Accordingly, the redemption feature would not be a separate "contractual obligation to sell the stock," as required in order for section 246(c)(4)(A) to apply. In response, however, it might be argued that Congress considered and rejected a similar argument in the context of applying the SSRP Standard to puttable preferred stock. The 1984 Act Conference Report states:

> The conferees intend that an investment in preferred stock coupled with an option to sell the stock will not be treated as a single instrument, for purposes of applying the substantially similar standard, without regard to whether the option trades separately from the stock.[28]

C. Stock Subject to Put Options

1. Put Options With Strike Price Set More Than 45 Days After Stock Is Acquired

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[27] Support for this argument is found in Revenue Ruling 69-265, 1969-1 C.B. 109, which considers whether, under two fact patterns involving a stock-for-assets acquisition, a right to exchange certain preferred shares for stock of the issuer's parent constitutes disqualifying consideration other than shares of the issuer ("other property") for purposes of Section 368(a)(1)(C). The ruling holds that a right to present the preferred shares to the parent of the issuer in exchange for stock of the parent constitutes a right separate from the preferred shares, and is therefore "other property." By contrast, the right to present the preferred shares to the issuer in exchange for stock of its parent owned by the issuer is "in effect the right to have the [preferred shares] redeemed for specified property of [the issuer]," which does not constitute "other property" than the preferred shares themselves.

[28] H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 818 (1984). The 1984 Act Blue Book contains similar language. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 143 (1984). Based on the language used, it seems likely that the option to sell referred to in the Conference Report ran against a third-party rather than the issuer of the stock, thus presenting a stronger case for bifurcation under the rationale of Revenue Ruling 69-265, supra.

A taxpayer should not be considered to have "an option to sell" stock that tolls the DRD holding period under section 246(c)(4)(A) if the strike price for the option is set more than 45 days after the stock is acquired, based on then-market value. In such transactions, the strike price is set by reference to market values on the date that the strike price is fixed. Obviously, the holder is not protected against the risk of price fluctuations prior to the date that the strike price is fixed. Accordingly, no option to sell should be considered to exist until that date.[29]

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29 There is no reason to construe the words "option to sell" in section 246(c)(4)(A) so literally as to treat the con-tract between the holder and the put writer as such an option prior to the fixing of the strike price. In the context of section 318(a)(4), the Service has construed the term option as not including rights to acquire stock contingent on the occurrence of events outside the holder's control (not including the passage of time). L.R. 8936016 (June 8, 1989) (warrant exercisable only if corporation issues additional common stock prior to the expiration date of the warrant is not an option for purposes of attribution under section 318 until additional common stock is issued); L.R. 8106008 (October 21, 1980) (a right of first refusal is not an option for purposes of section 318 because the holder of the right cannot cause the sale of the stock "to occur without any contingencies"). Without reaching the question whether a similar standard should be adopted in the section 246(c) context, it seems clear that the Service is within its authority not to regard the taxpayer as holding a put during the period before the strike price is fixed, and the taxpayer is without downside risk protection.

The decision in The Progressive Corp. v. United States, 970 P.2d 188 (6th Cir. 1992), rev'q 91-1 U.S.T.C.H 50,061 (D. Ohio 1990), does not require a different result. Addressing a situation in which the taxpayer had entered into a so-called forward conversion (long stock, short call and long put, the latter two positions equating to a synthetic short position), the District Court held that section 246(c) was inapplicable because the taxpayer was not in a short position as required by Treas. Reg. § 1.246-3(d)(2). (That regulation provides for the reduction of the DRD holding period "for any period that the taxpayer's stock holding is offset by a corresponding short position resulting from an option to sell, a contractual obligation to sell [etc.].") The Appeals Court correctly reversed, reasoning that the statute was clear in its application to the put held by the taxpayer, and that the DRD holding period accordingly was tolled.

2. Options to Put Stock to Issuer

The regulations should address whether a holder is considered to have "an option to sell" stock if the stock is puttable to the issuer. Some of the same considerations that argue against treating the holder of preferred stock subject to mandatory redemption as being under a contractual obligation to sell the stock—the option is subject to legal availability of corporate assets, and lack of significant risk reduction to the extent that the option is not immediately exercisable--argue against treating the holder of an option to put stock to the issuer as having an option to sell the stock.[30]

As in the case of mandatorily redeemable preferred stock, the argument can be made that a right to put stock to the issuer is an inherent component of the stock itself, rather than a separate position. Accordingly, the put right should not be viewed as "an option to sell" the stock within the meaning of section 246(c)(4)(A). As in the case of redeemable preferred

[30] See also L.R. 8610016 (November 29, 1985) holding that a right to exchange preferred stock for a fixed dollar amount of common stock of the same issuer did not trigger section 246(c), partly because the holder's exchange right did not technically represent a contract to sell; also because the amount of common stock receivable in the exchange was subject to certain adjustments by the issuer which could result in the holder's obtaining less than the fixed dollar amount in some circumstances; and finally because the common stock could fluctuate in value prior to sale by the holder. The ruling is probably subject to some criticism. First, case law has in some circumstances downplayed technical differences between the use of the terms sale and exchange in the Internal Revenue Code. See Gruver v. Commissioner, 142 F.2d 363 (4th Cir. 1944) ("[i]t is no distortion of language to employ the term 'sale' so as to cover or include an exchange of property"). Second, the fact that downside risk is not eliminated would not appear relevant if the instrument results in substantial diminution of such risk.

stock, Congress arguably considered and rejected a similar argument.[31]

D. Stock with Respect to Which Holder Has Granted Call Option

Section 246(c)(4)(B) provides that the DRD holding period is tolled during any period in which the taxpayer is the grantor of an option to buy SISS. However, this rule does not apply to a taxpayer that has granted a qualified covered call option as defined in section 1092(c)(4). We recommend that the grant of call options that are not qualified covered call options--because, for example, they are not listed options--should toll the DRD holding period only if the grant of the call option materially diminishes the taxpayer's risk of loss of holding the stock. Thus, for example, granting an out-of-the-money call option should not toll the DRD holding period.[32]

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[31] See note 28, supra. See also Revenue Ruling 90-27, 1990 C. B. 50, 51, stating, in the context of auction rate preferred stock, that the issuer's practical obligation to redeem such stock in the event of a failed auction would constitute, in substance, a right on the part of the holder to put such stock to the issuer, thereby implicating section 246(c)(4)(A).

[32] In the 1986 Act, Congress clarified that the 1984 Act did not change the principle that the DRD is not disallowed in such a case. See S. Rep. No. 313, 99th Cong., 2d Sess. 906 (1986); H.R. Rep. No. 426, 99th Cong., 1st Sess. 890 (1985); Explanation of Technical Corrections to the Tax Reform Act of 1984 17 (1987). This principle was applied before the 1984 Act in Revenue Ruling 80-238, 1980-2 C.B. 96 and Gen. Couns. Mem. 38305 (March 11, 1980). Since the 1986 legislative history did not accompany an amendment to this particular aspect of section 246(c), its interpretive value might be reduced.

There is also merit in extending such treatment to in-the-money non-listed options that are not deep in-the-money. For this purpose we would refer to the criteria in section 1092(c)(4);. thus, an option with a strike price that is not less than 85% of the relevant stock price, and that has a period to expiration (at the time of grant) in excess of 30 days, ought not to toll the DRD holding period.

We note that section 246(c)(4)(C) operates where the taxpayer's risk is “diminished”; unlike the tax straddle context of section 1092(c)(2)(A), there is no requirement that risk be “substantially” diminished. Notwithstanding, it appears that the problem at which section 246(c) was directed was material or significant risk reduction—as suggested by the exclusions from the section 246(c) for qualified covered calls and strategies that hedge general market risk. We think unlisted calls that conform to the qualified covered call criteria as described above do not involve the material risk reduction that is the focus of section 246(c).

E. Payments Under Equity Swap Contracts

An equity swap transaction, in essence, replicates the economic attributes of stock ownership. An equity swap is a contract between two parties: one party corresponds to the owner of the stock that has purchased the stock with 100% debt financing; the other party corresponds to someone who has effected a short sale of the stock. Although the terms of equity swaps can vary, in general, the long side of the contract (i) is entitled to receive an amount equal to the dividends paid on the stock, (ii) is entitled to receive an amount equal to the appreciation in value of the stock during the time that the contract is in effect (or during shorter intervals as agreed by the parties), (iii) is required to pay interest on a notional principal amount equal to the value of the stock, and (iv) is required to pay an amount equal to the depreciation in value of the stock during the term of the contract (or other interval agreed to by the parties).[33]

Because the party on the short side of the equity swap transaction is in the same position as a taxpayer that makes dividend substitute payments, section 246(c)(1)(B) should apply to deny the DRD.[34] a swap contract with payments equal to last year's dividend on the stock, for example, or actual dividends with a cap and a floor, presents a more difficult issue. Regulations should adopt a facts-and-circumstances test that turns on how closely the payments under the swap can be expected to mirror the dividends paid.[35]

If a taxpayer that is long stock is on the short side of an equity swap, the taxpayer is insulated from the risk of price changes. We think it is appropriate for the Service to treat such

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33 A discussion of equity swap transactions appears in New York State Bar Association Tax Section, “Report on Proposed Regulations on Certain Payments Pursuant to Securities Lending Transactions” (July 7, 1992).

34 That is, such a payment obligation appears to represent an “obligation . . . to make related payments with respect to” SISS, and accordingly would be subject to section 246(c)(1)(B) prior to the issuance of regulations defining the SSRP Standard. Even though the party on the short side of an equity swap may be viewed as having a position in SISS, it would appear difficult to apply the holding period tolling rule of section 246(c)(4)(A) to such a taxpayer, since an equity swap does not involve an option to sell stock, a contractual obligation to sell stock or a short sale of stock.

35 cf. Prop. Reg. section 1.1275-5(b)(2) (cap and similar restrictions on floating rate interest prevent qualification of debt as a variable rate debt instrument if the restriction “is very likely to cause the interest rate in one or more accrual periods, known as of the issue date, to be significantly less than the overall expected return on the debt instrument”). Here the question is whether it is likely that actual periodic payments in lieu of dividends will be significantly more or less than the expected dividends on the stock.

transactions as SSRP under section 246(c)(4)(C), thereby tolling the DRD holding period; for the reasons articulated above, we think such treatment should be prospective.[36]

[36] See part IV.A.2 of the report. As discussed in note 34, supra, it does not appear that the short side of an equity swap would implicate section 246(c)(4)(A).