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An Examination of the Effect of Recent Legislation on Commodity Tax Straddles

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AN EXAMINATION OF THE EFFECT OF RECENT LEGISLATION ON COMMODITY TAX STRADDLES

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During the Senate Finance Committee hearings on commodity tax straddles on June 12, 1981, Senator Matsunaga (D-Hawaii) said that he did not quite understand the problem with tax straddles. Senator Long (D-Louisiana) immediately responded: "I will tell you what the problem is all about; it's about people making a lot of money but paying no taxes."[1]

The dimensions of this problem are clearly illustrated by a report of the Joint Committee on Taxation that analyzed the returns of several representative taxpayers who had claimed straddle losses:

> The shelter returns included an individual return which sheltered more than $5,500,000 of capital gain with silver contract losses (and approximately $520,000 of ordinary income with Treasury bill straddle losses) . . . . On another return, a long-term capital gain in excess of $600,000 from the sale of securities was deferred with silver straddle losses exceeding $800,000 . . . .
> Three individual returns sheltered more than $11,000,000 ($11 million) with Treasury bill losses . . . .
> One middle-income administrator used $100,000 in T-bill losses to offset $60,000 of wages, and $40,000 of interest and other income . . . . An executive, earning $60,000, claimed T-bill losses of $395,000 to wipe out most of $420,000 in interest and commis-

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[1] The author was present in the Senate hearing room at the time of this exchange. The text reflects the substance of the Senators' comments, if not the precise wording.

> sions . . . . Losses of $290,000 on T-bill options were claimed by a loan broker. Shelter losses and itemized deductions totalled $440,000, offsetting most of the $580,000 in wages earned by the broker . . . .
>
> [A]t least one return claim[ed] losses on cancellation of GNMA contracts to shelter about $420,000 from tax.[2]

As could be expected, the Internal Revenue Service challenged the validity of these straddles by means of doctrines traditionally used to combat tax avoidance strategies, such as the step transaction doctrine.[3] In 1981, Congress stepped in with a more comprehensive solution to the problem. It enacted, as part of the Economic Recovery Tax Act of 1981 (ERTA), several provisions designed to eliminate the use of straddles for income deferral and conversion of short-term capital gain or ordinary income into long-term capital gain.[4] The most important provisions added to the Internal Revenue Code are section 1256, which creates a mark to market system for regulated futures contracts (RFCs),[5] and section 1092, which imposes a disallowance of loss rule on non-RFC straddle transactions.[6]

The Technical Corrections Act of 1982 made several changes in the new straddle provisions.[7] In general, it brought both bank forward contracts and cash settlement contracts under section 1256 governing RFCs.[8] These legislative changes will be discussed below in conjunction with the discussion of the relevant provisions of ERTA.

This article introduces the anti-straddle provisions and presents some policy reflections on these provisions. The historical development of the tax straddle problem and the legislative history of the

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[2] *Commodity Tax Straddles, Hearing Before the House Comm. on Ways and Means*, 97th Cong., 1st Sess. 6, 7 (1981) (report by the Staff of the Joint Committee on Taxation submitted by Congressman Brodhead) [hereinafter cited as House Hearing].

[3] *See* discussion of Rev. Rul. 77-185 and *Smith v. Commissioner*, notes 10-31 *infra* and accompanying text.

[4] *See* Pub. L. No. 97-34, 95 Stat. 172 (1981).

[5] *See* I.R.C. § 1256(a).

[6] *See id.* § 1092(a).

[7] *See* Pub. L. No. 97-448, 96 Stat. 2365 (1983).

[8] *See* Conference Report on H.R. 6056, Technical Corrections Act of 1982, 97th Cong., 2d Sess., 128 Cong. Rec. H10696, H10701-02 (daily ed. Dec. 21, 1982) [hereinafter cited as Conference Report]. *See also* Pub. L. No. 97-448, § 105, 96 Stat. 2365, 2384-85.

straddle provisions of ERTA are explored in Part I.[9] Part II examines the new mark to market system for RFCs, and Part III considers the disallowance of loss rule (and related wash sale and short sale rules) for non-RFC straddles. Part IV examines some of the miscellaneous provisions of Title V of ERTA, including the cash and carry rule, the hedging exemption, the classification of Treasury bills, the treatment of terminations, and the identification requirement for securities dealers. Finally, some policy reflections are provided in Part V.

I. Historical Development of the Anti-Straddle Provisions

A. *Development and Recognition of the Straddle Problem*

The transaction addressed by Revenue Ruling 77-185[10] is an excellent example of the abuse at which the straddle provisions of ERTA are aimed. The taxpayer had realized short-term capital gains from the sale of real property in 1975.[11] To minimize the tax consequences of the gain, the taxpayer entered into a series of silver futures straddles.[12]

On August 1, 1975, the taxpayer simultaneously sold (i.e., entered into contracts to sell) forty silver futures contracts for July 1976 delivery (the short leg) and bought (i.e., entered into con-

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[9] For background information on commodities and futures trading, see T. Hieronymus, *Economics of Futures Trading* (2d ed. 1977). For a discussion of the tax treatment of futures and related transactions under prior law, see Dailey, *Commodity Straddles in Retrospect: Federal Income Tax Considerations*, 47 Brooklyn L. Rev. 313 (1981); Goldfein and Hochberg, *Use of Commodity Straddles Can Effect Impressive Tax Savings*, 29 J. Tax'n 342 (1968); Schapiro, *Tax Aspects of Commodity Futures Transactions, Forward Contracts and Puts and Calls*, 39 N.Y.U. Inst. on Fed. Tax'n § 16 (1981); Selig and Schmittberger, *Tax Aspects of Commodity Futures Trading*, 6 Hofstra L. Rev. 93 (1977); Turlington, *The Long and Short of Straddles as a Tax Saving Device: An Historical Update of Revenue Ruling 77-185*, 40 N.Y.U. Inst. on Fed. Tax'n § 16 (1982). For a persuasive argument for the reform of prior law, see Schapiro, *Commodities, Forwards, Puts and Calls—Things Equal to the Same Things are Sometimes Not Equal to Each Other*, 34 Tax Law. 581 (1981) . For comments on the taxation of straddles under ERTA, see articles cited at note 67 *infra*.

[10] 1977-1 C.B. 49, *amplified by* Rev. Rul. 78-414, 1978-2 C.B. 213.

[11] *See id.*

[12] *See id.* Because the legs of the straddle tend to move in opposite directions with any increasing loss on one leg being balanced by increasing profit on the other, the risk of the straddle transaction is limited to the spread, or difference in value, of the legs of the straddle when the taxpayer first enters into the transaction. Since the risk is limited, the amount the futures trader is required to deposit in his margin account with an exchange is low. The taxpayer can therefore defer large amounts of income while actually investing (or losing the economic use of) a relatively small amount of money.

tracts to buy) forty silver futures contracts for March 1976 delivery (the long leg).[13] Three days later, after the price of silver had decreased, the taxpayer closed out[14] the long leg at a loss and immediately replaced the leg by purchasing another forty silver futures contracts for May 1976 delivery.[15] On February 18, 1976, the taxpayer again closed out the long leg of the straddle (now the forty silver futures contracts for May 1976 delivery), this time at a gain, and also closed out the short loss leg. These transactions enabled the taxpayer to offset his 1975 short-term gain from the sale of real estate with the short-term loss from the sale of the March 1976 silver futures.[16] The gain from the sale of the May 1976 futures was reported as long-term gain in 1976 and was partially offset by the short-term capital loss from the closing of the short leg of the straddle.[17] The net gain realized in 1976 was approximately equal to the loss realized in 1975.[18] Thus, by using the silver futures straddles, the taxpayer deferred tax on his short-term capital gain and converted that gain into long-term capital gain.

Revenue Ruling 77-185 denied the taxpayer a deduction for the short-term capital loss generated by the August 4, 1975 sale of the loss leg.[19] The Service took the position that the sale immediately followed by the replacement of the leg "resulted in no real change of position in a true economic sense, and [did] not represent a closed and completed transaction."[20] The Service also disallowed the loss because "[t]he taxpayer had no reasonable expectation of deriving an economic profit from the transactions,"[21] and the loss, therefore, failed to meet the requirements of section 165(c)(2).[22]

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[13] *See id.*

[14] The closing transaction is effectuated by selling identical offsetting short futures contracts.

[15] *See* 1977-1 C.B. 49. Thus, the taxpayer recognized a loss equal to the difference between the purchase price and the lower sale price for the 40 silver futures contracts maturing in March 1976. However, since the taxpayer immediately reestablished the long leg of the straddle, the actual amount which he had at risk remained relatively small.

[16] *See id.*

[17] *See id.*

[18] *See id.*

[19] *See id.*

[20] *Id.* at 50. The Service relied on MacRae v. Commissioner, 34 T.C. 20 (1960) and Horne v. Commissioner, 5 T.C. 250 (1945), to support its holding.

[21] 1977-1 C.B. at 50.

[22] *See id.* I.R.C. § 165(c)(2) allows individuals to deduct under § 165(a) any losses incurred in a transaction entered into for profit, even though not connected with a business or

As discussed more fully below, the wash sale rule of section 1091 does not apply to commodity futures[23] and the short sale rule of section 1233 does not apply to commodity futures requiring delivery in different calendar months.[24] Neither provision was therefore available to the Service to block the use of commodity futures straddles as tax avoidance devices. If the wash sale rule had applied to the above transaction, it would have prevented deferral by disallowing the 1975 loss because of the reestablished long position.[25] If the short sale rule had applied, the taxpayer's gain in 1976 would have been considered short-term capital gain, thereby preventing conversion.[26]

The Service recently litigated its position in Revenue Ruling 77-185 in *Smith v. Commissioner*,[27] where it challenged the deductibility of losses claimed in "butterfly straddles."[28] The Service proceeded on several different theories:

> (1) The losses were not genuine;
> (2) The transactions had to be stepped together and the losses recognized only upon the conclusion of the scheme;
> (3) The transactions lacked economic substance; and
> (4) The losses were not deductible under section 165(c)(2) because they were not incurred in transactions entered into for profit.[29]

The Tax Court rejected the Service's first three arguments[30] but accepted the fourth on the grounds that the relevant transaction for section 165(c)(2) purposes was the petitioner's entire commodity tax straddle scheme and the petitioner had no non-tax motive for entering into the transaction.[31]

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trade. *See* I.R.C. § 165(c)(2).

[23] *See* note 212 *infra* and accompanying text.

[24] *See* note 231 *infra* and accompanying text.

[25] *See* I.R.C. § 1091(a).

[26] *See id.* § 1233(b).

[27] 78 T.C. 350 (1982). For an excellent analysis of the *Smith* case, see Note, *The Tax Straddle Cases*, 1982 Duke L.J. 114, 125 (1982).

[28] 78 T.C. at 358. A butterfly straddle consists of two separate straddles and is designed to reduce the risk of loss. In the *Smith* case, the straddles initially consisted of (1) a long position in March 1974 silver futures and a short position in July 1974 silver futures, and (2) a long position in December 1974 silver futures and a short position in July 1974 silver futures. *See id.*

[29] *Id.* at 370.

[30] *See id.* at 376, 385, 390.

[31] *See id.* at 391. The "hope of deriving an economic profit aside from the tax benefits need not be reasonable so long as it is bona fide." *Id.* However, the petitioner failed to

As will be seen below, the new mark to market rule of section 1256 applies to futures transactions like the ones in Revenue Ruling 77-185 and *Smith v. Commissioner.*[32] If that section had been applicable to the transactions discussed above, the contracts that remained open at year's end would have been deemed to have been disposed of in taxable transactions.[33] As a consequence, the taxpayer could not have deferred his gain.[34] If those straddle transactions had been effectuated in property other than RFCs[35] and the new disallowance of loss rule of section 1092 had been applicable, the loss claimed in 1975 from the disposition of the loss position would have been deferred until 1976, the year in which the offsetting gain positions were disposed of, and the gain would have been treated as short-term capital gain.

B. Legislative Development of the Straddle Provisions of ERTA

An early legislative proposal to limit the use of commodity straddles as tax shelters relied primarily on the concept of loss disallowance.[36] This bill, cosponsored by Representatives Charles Vanik (D-Ohio) and Benjamin Rosenthal (D-New York), would have denied any deduction on the sale of the loss leg of a straddle until thirty days after the taxpayer had ceased to be in a straddle position.[37] If the taxpayer had reestablished the straddle within that thirty day period, the loss would not have been recognized. In essence, this would have codified the Service's position in Revenue

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satisfy the burden of proof on this issue. *See id.* at 394.

[32] *See* notes 92-134 *infra* and accompanying text.

[33] *See* I.R.C. § 1256(a).

[34] However, the taxpayer's net gain would have been taxed at a maximum rate of 32%. *See* note 100 *infra* and accompanying text.

[35] A straddle could be created, for example, with forward contracts. Forward contracts, unlike futures contracts, involve transfers of ownership of physical goods and are traded in "informal, decentralized markets." *See* Hieronymus, *supra* note 9, at 32. Typical examples of cash forward contracts are the sale of corn in October by a farmer for delivery to a local elevator in January, the sale by the elevator in November for delivery to an exporter in March, and the sale by the exporter in December for delivery at a foreign port in April. *See id.*

[36] *See* H.R. 7541, 96th Cong., 2d Sess., 126 Cong. Rec. H4739 (daily ed. June 10, 1980). *See also Vanik-Rosenthal Bill Would Limit Use of Commodity Straddles for Tax Sheltering*, [June 1980] Daily Tax Rep. (BNA) No. 113, at G-6 (June 10, 1980).

[37] *See* H.R. 7541, 96th Cong., 2d Sess., 126 Cong. Rec. H4739 (daily ed. June 10, 1980).

Ruling 77-185.[38] The Vanik-Rosenthal bill also would have prevented the use of straddles as a means of converting short-term capital gain into long-term by suspending the holding period of any property that was part of a straddle for so long as the taxpayer was considered to maintain the straddle.[39] However, the bill was not acted upon and formally died with the end of the Carter administration.

The Treasury under Carter also worked on a possible legislative solution to the problem of commodity tax straddles. In the last days of the Administration, the outgoing Assistant Secretary of Treasury for Tax Policy, Donald Lubick, sent the Treasury's proposals to Senator Moynihan (D-New York) in response to the Senator's inquiry.[40] The proposals included rules, similar to those in the Vanik-Rosenthal bill, for the disallowance of loss and the suspension of the holding period for property held in a straddle.[41] The Treasury also developed several other miscellaneous anti-straddle measures, all of which were eventually incorporated into the final version of the straddle provisions.[42]

Congress' concern with tax straddles did not diminish with the change of administrations. On January 27, 1981, Representatives Rosenthal and Brodhead (D-Michigan) introduced legislation similar to the Vanik-Rosenthal bill,[43] and on March 5, 1981, Senator Moynihan introduced a bill modeled on the Carter Treasury proposals.[44] These bills carried forward the idea of suspending the

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[38] *See* notes 10-22 *supra* and accompanying text.

[39] *See* H.R. 7541, 96th Cong., 2d Sess., 126 Cong. Rec. H4739 (daily ed. June 10, 1980). The holding period would remain suspended throughout the thirty day loss disallowance period.

[40] *See* Letter from Donald C. Lubick to Senator Moynihan (Dec. 23, 1980) *reprinted in* [Jan. 1981] Daily Tax Rep. (BNA) No. 12, at J-2 (Jan. 19, 1981).

[41] *See id.*

[42] The additional proposals were for a capitalization requirement for cash and carry transactions, the reclassification of Treasury bills as capital assets, a one-day identification requirement for securities to be held in a dealer's investment account, and the treatment of terminations as sales or exchanges, *See id.* at J-5-7. The versions of these proposals as enacted are respectively Pub. L. No. 97-34, §§ 502, 505-07, 95 Stat. 172, 327, 331-33 (1981). *See* respectively I.R.C. §§ 263(g), 1221(5) (deleted), 1234, 1236.

[43] Rep. Rosenthal introduced H.R. 1338, 97th Cong., 1st Sess. (1981) (text found at [Jan. 1981] Daily Tax Rep. (BNA) No. 18, at J-1 (Jan. 28, 1981)), and Rep. Brodhead introduced H.R. 1293, 97th Cong., 1st Sess. (1981). The two bills are identical.

[44] *See* S. 626, 97th Cong., 1st Sess. (1981); *Hearing on S. 626 Before the Senate Subcomm. on Taxation and Debt Management and the Subcomm. on Energy and Agriculture Taxation of Committee on Finance*, 97th Cong., 1st Sess. 4 (June 12, 1981) (reprint of bill)

holding period of straddle property and of denying recognition of losses sustained within a straddle.[45] The loss disallowance rule would have applied if the taxpayer held "offsetting positions" in "personal property."[46] A taxpayer was considered to hold an "offsetting position" if his risk of loss from holding any position in personal property was substantially diminished because of also holding one or more other positions in personal property, whether or not the personal properties held were of the same kind.[47] The bills also incorporated the other measures suggested by Mr. Lubick, such as changing the classification of Treasury bills from ordinary income items to capital assets[48] and requiring the capitalization of carrying costs in cash and carry transactions.[49]

When the Reagan Administration's new Assistant Secretary of Treasury for Tax Policy presented the position of the Reagan Treasury at the House Ways and Means hearings on the Brodhead-Rosenthal bill in April of 1981, he made essentially the same legislative suggestions as his predecessor, Mr. Lubick.[50] However, there was one crucial difference. The new Assistant Secretary, John Chapoton, urged the adoption of a mark to market rule for persons who had a significant volume of trading in regulated futures contracts.[51] He explained: "Because futures positions are

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[hereinafter cited as Hearing on S. 626].

[45] *See* H.R. 1338, 97th Cong., 1st Sess. (1981); H.R. 1293, 97th Cong., 1st Sess. (1981); S. 626, 97th Cong., 1st Sess. (1981).

[46] *See id.*

[47] *See id.* The Lubick proposals spoke in terms of "balanced" positions but similarly defined such positions with reference to "substantial diminution of loss". The House and Senate bills followed the lead of the Treasury proposals in establishing certain positions as presumptively offsetting. For a comparison of the presumptions created by the Brodhead-Rosenthal bill and the Moynihan bill, see House Hearing, *supra* note 2, at 368-70 (report of New York State Bar Association, Tax Section). *Cf.* Pub. L. No. 97-34, § 501(a), 95 Stat. 172, 323-24 (1981); I.R.C. § 1092(c)(3).

[48] *See* H.R. 1338, 97th Cong., 1st Sess. (1981); H.R. 1293, 97th Cong., 1st Sess. (1981); S. 626, 97th Cong., 1st Sess. (1981).

[49] *See id.*

[50] *See* House Hearing, *supra* note 2, at 60, 65 (statement of John E. Chapoton, Asst. Sec'y for Tax Policy, Dept. of Treasury).

[51] *See id.* at 71. In his prepared statement, Mr. Chapoton explained the reason for this proposal:

> Most often, this rule would apply to persons who are traders in commodities. The volume of their transactions makes a balanced position rule, requiring the identification of particular positions, cumbersome to apply. There is also the risk that such a rule could be avoided by these market participants . . . .

Id.

marked to market on a daily basis under the normal operating rules of the exchange, with actual cash settlements on a daily basis, this rule does no more than make the tax laws reflective of the underlying market transactions."[52] Under his proposal, any taxpayer who entered into more than fifty futures transactions in at least three of the four quarters of a taxable year would have constructive realization of his open futures positions at year end.[53] Mr. Chapoton made the same suggestions to the Senate Finance Committee during its hearing on tax straddles on June 12, 1981.[54]

When the Senate Finance Committee adopted H.J. Res. 266, The Economic Recovery Tax Bill of 1981,[55] on July 12, 1981, it contained the mark to market approach recommended by Mr. Chapoton.[56] It extended this approach to all trading in RFCs and provided for a maximum tax rate of thirty-two percent on RFC gains.[57] The bill also contained the other proposals that had been initially outlined in Mr. Lubick's letter to Senator Moynihan.[58]

However, when the House Ways and Means Committee reported its version of the 1981 tax-cut bill out of committee on July 23, 1981,[59] it did not include the mark to market approach. Instead, at

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[52] *Id.*

[53] *See id.*

[54] *See* Hearing on S. 626, *supra* note 44, at 63 (remarks by Chapotón).

[55] *See* H.J. Res. 266, 97th Cong., 1st Sess. (1981) (as amended by the Senate Finance Committee); S. Rep. No. 144, 97th Cong., 1st Sess., *reprinted in* 1981 U.S. Code Cong. & Ad. News 105.

[56] *See* H.J. Res. 266, 97th Cong., § 503, 1st Sess. (1981) (as amended by the Senate Finance Committee); S. Rep. No. 144, 97th Cong., 1st Sess. 157-58, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 256-57. *See also* notes 51-54 *supra* and accompanying text.

[57] *See* H.J. Res. 266, 97th Cong., § 503(a), 1st Sess. (1981) (as amended by the Senate Finance Committee); S. Rep. No. 144, 97th Cong., 1st Sess. 157-58, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 256-57.

[58] *See* H.J. Res. 266, 97th Cong., Title V, 1st Sess. (1981) (as amended by the Senate Finance Committee); S. Rep. No. 144, 97th Cong., 1st Sess. 154-61, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 253-60. *See also* notes 40-42 *supra* and accompanying text. The tax straddle provisions of ERTA as finally adopted are essentially the same as those adopted by the Senate Finance Committee. Most of the guidelines on the operation of ERTA can be found in the Senate Finance Committee Report, S. Rep. No. 144, 97th Cong., 1st Sess., *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, and in the Joint Committee's General Explanation of the Economic Recovery Tax Act of 1981. *General Explanation of the Economic Recovery Tax Act of 1981*, 97th Cong., 1st Sess. (J. Comm. Print 1981) (prepared by the Staff of the Joint Committee on Taxation) [hereinafter cited as General Explanation].

[59] *See* Tax Incentive Bill of 1981, H.R. 4242, 97th Cong., 1st. Sess., 127 Cong. Rec. H5178 (daily ed. July 29, 1981) (reprint of text).

the urging of Congressman Marty Russo, (D-Illinois), the Committee adopted a "basket" approach which was supported by the commodities industry.[60] This approach limited the amount of commodity losses that could be deducted to the amount of gains from commodity transactions.[61] In other words, commodity traders who derived most of their income from commodity transactions could have continued to roll their income forward through the use of commodity straddles, but ordinary investors would no longer have been able to use straddle transactions to defer or convert noncommodity gains.[62]

The Reagan administration introduced a "substitute" for the House Ways and Means tax bill.[63] Despite substantive differences between the two bills, the provisions dealing with commodity straddles were similar. Even though Mr. Chapoton had supported the mark to market approach, the "substitute" followed the "basket" approach of the House Ways and Means bill,[64] and the full House adopted this "substitute" bill.[65]

But on August 1, 1981, the Conference Committee adopted the Senate version of the straddles portion of ERTA, and, as a result, the mark to market concept and other straddle provisions were ad-

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[60] *See* H.R. Rep. No. 201, 97th Cong., 1st Sess. 197-202 (1981). *See also Commodity Trading PACs Gave to Tax Unit Members Before Vote*, Wash. Post, Aug. 8, 1981, at A5, col. 1.

[61] *See* H.R. Rep. No. 201, *supra* note 60, at 198-99. The House Committee Report further describes the basket approach:

> The bill disallows losses on commodity straddles to the extent such losses exceed gains from both straddle transactions and net nonstraddle commodity transactions. The rule is designed to limit the use of straddle losses to defer income which is not related to commodity transactions and to prevent conversion of such income from short-term capital gain into long-term capital gain.
>
> Gain which limits the current deductibility of straddle losses is gain from both straddle transactions and non-straddle commodity transactions which are sales, exchanges, or other dispositions of specified commodity-related property.

Id. at 198.

[62] *See Ways and Means Votes Straddle Exemption for Traders*, 13 Tax Notes (Tax Analysts) 190 (July 20, 1981).

[63] *See* H.R. 4260, 97th Cong., 1st Sess. (1981) (introduced by Reps. Conable and Hance). For an in-depth discussion of the respective merits of H.R. 4242, as reported out of the Ways and Means Committee, and H.R. 4260, see 127 Cong. Rec. H5127-70 (daily ed. July 29, 1981) (floor debate).

[64] *See* H.R. 4260, *supra* note 63, § 501.

[65] *See* H.R. 4242, 97th Cong., 1st Sess. (as passed by the House on July 29, 1981). As passed by the House, H.R. 4242 was amended by the substitute co-authored by Representatives Conable and Hance, which the White House helped draft. *See id.*

ded to the law.[66] These straddle provisions were the major revenue raising provisions in the largest tax cut act in history.[67]

II. Tax Treatment of Regulated Futures Contracts

Section 1256, which was added by ERTA, radically changes prior law by requiring that all open RFCs be marked to market at year end.[68] Thus, gains and losses from RFCs acquired after July 23, 1981 are taxed, in essence, on an accrual basis.[69] The gains and losses from both open and closed RFCs are subject to a special tax rate that, in general, equals thirty-two percent of the gains.[70]

This part of the article will first discuss the definition of an RFC and then examine the operation of the mark to market rule. Finally, the treatment of mixed straddles will be considered.

A. *RFC Defined*

As a result of the Technical Corrections Act of 1982,[71] the term RFC is defined as a contract:

> (1) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of

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[66] A brief overview of the legislative history of ERTA is found at the front of the Joint Committee's General Explanation of the new law. *See* General Explanation, *supra* note 58, at 3-4.

[67] For discussions of various aspects of the tax straddle provisions, see Bowers, *New Law Eliminates Most Tax Straddle Benefits: An Analysis of the Drastic Changes*, 55 J. Tax'n 338 (1981); Bowers, *Straddle Rules Do Not Apply to Hedging Transactions but Bar Other Tax-Savings Methods*, 56 J. Tax'n 24 (1982); Schapiro, *Commodities and Tax Straddles Under the Economic Recovery Tax Act of 1981*, 34 Major Tax Plan. 3-1 (1982): Shashy, *The Long and Short of Straddles as a Tax Saving Device: New Law*, 40 N.Y.U. Inst. on Fed. Tax'n § 17 (1982); Strauss, *An Analysis of the Tax Straddle Provisions of the Economic Recovery Tax Act of 1981*, 60 Taxes 163 (1982).

[68] *See* Pub. L. No. 97-34, § 503, 95 Stat. 172, 327-30 (1981).

[69] In general, ERTA applies to positions established after June 23, 1981. *See* Pub. L. No. 97-34, § 508(a), 95 Stat. 172, 333 (1981). Taxpayers may elect to have the straddle provisions apply to all positions held on June 23, 1981. *See id.*, § 508(c), 95 Stat. at 333. Alternatively, taxpayers may elect to have § 1256 apply to RFCs held during taxable years beginning before June 23, 1981 and ending after June 22, 1981. *See id.*, § 509, 95 Stat. at 333-34. Those taxpayers who choose to make this latter election may also elect to defer payment of part of the tax over a period of up to five years with interest. Temporary Regulations dealing with these elections were promulgated as Treasury Decision 7826 on September 2, 1982. *See* Temporary Treas. Reg. § 5(c).1256-1 to .1256-3 (1982). This article does not deal with these election provisions.

[70] *See* note 100 *infra* and accompanying text.

[71] *See* Pub. L. No. 97-448, 96 Stat. 2365 (1983).

> marking to market; and
> (2) which is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission ["CFTC"] or of any board of trade or exchange which the Secretary determines has rules adequate to carry out the purposes of this section.[72]

There are two basic elements to this definition: (1) the presence of a mark to market system; and (2) a contract traded on a board of trade or exchange.

The Technical Corrections Act of 1982 amended section 1256(b) to eliminate the former requirement of delivery of personal property or of an interest in such property.[73] The purpose of this change was to bring cash settlement futures contracts within the definition of an RFC.[74] These contracts do not provide for the delivery of personal property, such as a corn futures contract, but call for cash settlement only. Some contracts provide for cash settlement as an alternative to the delivery of personal property. The Technical Corrections Act overrides the position taken by the Joint Committee on Taxation at the time ERTA was enacted to the effect that (1) cash settlement contracts could not be RFCs because cash is not "personal property" for purposes of section

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[72] Pub. L. No. 97-448, § 105(c)(5), 96 Stat. 2365, 2385 (1983); I.R.C. § 1256(b).

[73] *See* Pub. L. No. 97-448, § 105(c)(5), 96 Stat. 2365, 2385 (1983); I.R.C. § 1256(b). Prior to the Technical Corrections Act, § 1256(b)(1) required "delivery of personal property (as defined in § 1092(d)(1)) or an interest in such property." Pub. L. No. 97-34, § 503, 95 Stat. 172, 327-30 (1981). Under § 1092(d)(1), personal property is defined as "any personal property (other than stock) of a type which is 'actively traded.'" I.R.C. § 1092(d)(1).

The delivery requirement of § 1256(b)(1) was satisfied by both futures contracts and cash forward contracts, although the two types of contracts are different in other respects. A futures contract is defined as "an agreement to later buy and sell a commodity." Hieronymus, *supra* note 9, at 31. Futures contracts are "standardized" and "identical with regard to all terms (quantity, quality, etc.) except the month of delivery and the price," and are traded on organized, centralized exchanges. *Id.* at 33. Cash forward contracts involve ownership transfers and transfers of the actual physical commodity. *See id.* at 32-33. Although they contain the same terms as futures contracts, cash forward contracts are not standardized and are traded in informal, decentralized markets. *See id.* For examples of cash forward contracts, see note 35 *supra*.

The Technical Corrections Act of 1982 amended § 1256(b) by deleting the delivery requirement. *See* Pub. L. No. 97-448, § 105(c)(5), 96 Stat. 2365, 2385 (1983).

[74] *See* Conference Report, *supra* note 8, at H10702. By its recent authorization of trading in cash settlement futures contracts, such as the Kansas City Board of Trade's contract in the Value Line Average stock index, the CFTC presented the tax issue that is addressed by this amendment.

1092, and (2) such contracts are subject to the offsetting position rule that applies to non-RFCs.[75]

As a matter of tax policy, the presence of a mark to market system is the key to a contract's designation as an RFC.[76] The mark to market system is described in the Senate Finance Committee Report:

> The United States commodity futures exchanges employ a unique system of accounting for every contract's gain or loss in cash on a daily basis. Even though a futures trader does not close out a position but continues to hold it, the trader receives any gain on the position in cash as a matter of right each trading day.
>
> If a trader's position has increased in value during the day, the net increase in the position is computed and transferred to the trader's account before the beginning of trading the next day. The trader has the right to withdraw the full amount of such gains immediately every trading day. However, if a trader's position decreases in value, the trader will have to meet a margin call, that is, deposit additional funds before the next business day. Money paid on position losses is paid into the exchange clearing association which

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[75] *See* General Explanation, *supra* note 58, at 289. The original Technical Corrections bill introduced in the House deleted the delivery of personal property requirement. *See* H.R. 6056, 97th Cong., § 105(c)(5), 2d Sess., 128 Cong. Rec. H6948, H6953 (daily ed. Sept. 14, 1982). *See also* Conference Report, *supra* note 8, at H10702. In contrast, the Senate amendment retained the former requirements of § 1256(b)(1), but provided "that cash settlement contracts requiring the delivery of an amount of cash determined by reference to the value of any property or index based on that value [would] meet the delivery of personal property requirement." Conference Report, *supra* note 8, at H10702. *See* H.R. 6056, 97th Cong., 2d Sess., 128 Cong. Rec. S12732, S12733 (daily ed. Sept. 30, 1982). The House amendment retained the original House provision and provided "that capital gain or loss [would] result from termination of a contract which does not require delivery of personal property, even though there is no sale or exchange, if the contract itself is a capital asset in the hands of the taxpayer." Conference Report, *supra* note 8, at H10702. The Conference agreement passed by Congress follows the House amendment. *See id.*; I.R.C. § 1234A(2). It was codified as an amendment to § 1234A which now reads as follows:

> SEC. 1234A. GAINS OR LOSSES FROM CERTAIN TERMINATIONS.
>
> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—
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> (1) a right or obligation with respect to personal property (as defined in § 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
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> (2) a regulated futures contract (as defined in § 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,
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> shall be treated as gain or loss from the sale of a capital asset.

I.R.C. § 1234A.

[76] *See* I.R.C. § 1256(b)(1).

transfers such amounts to accounts which gained during the trading day. This daily accounting which includes the determination of contract settlement prices and margin adjustments to reflect gains and losses is called 'marking-to-market'.[77]

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[77] S. Rep. No. 144, 97th Cong., 1st Sess. 156-57, *reprinted in* 1981 U.S. Code Cong. and Ad. News 105, 255-56. The report continues:

> Marking-to-market requires daily cash adjustments through the exchange clearing association to reconcile exchange members' net gains and losses on their positions. At the close of trading each day, every member must mark all customer accounts to the settlement prices (current market value) for the day. Gains and losses are immediately deposited into or withdrawn from the customer accounts. Customers in turn are entitled to withdraw their gains, or are required to deposit any margin required because of losses in their accounts at the close of every day under this marking-to-market system.

Id. at 157. The following is an example of the marking to market concept in a typical commodity futures transaction:

> On day *1* a customer goes to the wire office with the thought that the price of corn should rise. He signs a customer agreement, learns that the margin requirement is $1,000.00 per contract of 5,000 bushels or 20 cents per bushel and that he must maintain a minimum equity of $750 per contract or 15 cents per bushel, deposits $2,000, and buys 10,000 bushels of July corn at $2.80. He has made a contract to buy and pay for 10,000 bushels of number two yellow corn in store in a public warehouse in Chicago on which any day the following July the seller may elect to deliver, the additional details of the transaction to be governed by the rules and regulations of the Chicago Board of Trade. He is on his way to fame and fortune, particularly the latter. The next day he notes that something has gone wrong with the system and the price has gone down to $2.79. His position is worth a negative $100. He still has a credit balance and his equity is $1,900, more than the minimum $1,500 required. Perhaps tomorrow will be better. But it wasn't, the price declining to $2.78 ½. He now has a position value of negative $150 (1 ½ x 10,000 bushels) a credit balance of $2,000, and an equity of $1,850 which he notes is only $350 away from a margin call. The next day is worse with the price down 4¢ which he now instantly translates to $400 for a total loss of $550. He now lacks the minimum equity of $1,500 and his registered representative requests that he restore the original margin by depositing $550. If he does not make the deposit the position will be closed and he will have lost $550 and have to pay $70 in commission, leaving a credit balance of $1,380. It might be even worse if the selling order is filled at less than $2.74 ½ the next day. On day *5* he deposits $550, the price is unchanged so that his position value is still negative $550, his capital is $2,550 and his equity $2,000. On day *6* he decides that if a purchase of corn at $2.80 was a good thing $2.74 ½ is even better, he digs up another $2,000 for original margin, and buys 10 more July corn. He now has a capital of $4,550 and an equity of $4,000. Fortune shines on day *7* and the price goes up to $2.78 so that his equity is $4,700. On day *8* the price goes up two cents, making him look very good indeed. He has a position value of plus $550 (nothing on the first purchase and 4 ½¢ x 10,000 on the second), capital of $4,550 and equity of $5,100. This is all so good that he requests a check for the additional margin deposit of $550, reducing his capital and equity accordingly. The price continues to rise reaching $2.85. He has 5¢ profit on the first purchase and 10 ½¢ on the second for a total position value of $1,550. This plus the capital of $4,000 is a total of $5,550. Noting that he needs only $4,000

This system of daily accounting for unrealized gains and losses is unique to exchange traded futures contracts and does not exist in the case of other contracts such as forward contracts and the various types of exchange traded options. As will be seen below, Congress in essence made the policy judgment that it was appropriate to apply the constructive receipt doctrine to contracts that are traded on a mark to market system.[78]

With respect to the second requirement, that the contract be traded on a board of trade or exchange, it is not clear what types of boards of trade or exchange not regulated by the CFTC might be designated by the Secretary as having rules "adequate to carry out the purposes of section 1256."[79] Presumably, this designation could encompass foreign commodity exchanges, and at least one such exchange has formally requested to be so designated.[80]

The Technical Corrections Act added one final type of contract to the definition of an RFC.[81] New section 1256(b) now includes foreign currency contracts within the category of RFCs.[82] A "foreign currency contract" is defined in new section 1256(g) as a contract requiring delivery of a foreign currency in which positions are also traded through RFCs and which is traded in the interbank

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> margin he withdraws his $1,550 profit leaving only $2,450 capital and a total equity of $4,000. He could have left the money in and bought more, using the profit as margin. He might try to take out an additional $1,000 to reduce the equity to the maintenance margin of $3,000 but the house would probably refuse. On day *10* the price goes down to $2.84 reducing his position value to $1,350 and his equity to $3,800. He decides to quit, selling 20 July corn for $2.84. He has no margin requirement, no position value, his account is credited for $1,210 (1,350-140 commission) so that he has a credit balance of $3,660 which he may leave or withdraw.

Hieronymus, *supra* note 9, at 65-66.

[78] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 157, *reprinted in* 1981 U.S. Code Cong & Ad. News 105, 256.

[79] I.R.C. § 1256(b)(2).

[80] The London Commodity Exchange has requested such a designation. *See* Letter from Eugene T. Rossides, Esq., of Rogers & Wells, to the Honorable John E. Chapoton, Assistant Secretary for Tax Policy (Apr. 15, 1982) (on behalf of the London Commodity Exchange), *reprinted as* Tax Notes Documents No. 82-4950. A technical amendment has been submitted to the Treasury proposing that the Secretary "have the authority to determine on a retroactive basis that a foreign board of trade or exchange does not have rules adequate to carry out the purposes of § 1256." Letter from Eugene T. Rossides, Esq., of Rogers & Wells, to the Honorable John E. Chapoton, Assistant Secretary for Tax Policy (Oct., 1982), *reprinted as* Tax Notes Documents No. 82-9649.

[81] *See* Pub. L. No. 97-448, § 105(c)(5)(B), 96 Stat. 2365, 2386 (1983).

[82] *See* I.R.C. § 1256(b).

market.[83] The Technical Corrections House Report describes such contracts, also known as bank forward contracts, as follows:

> Trading in foreign currency for future delivery is conducted through regulated futures contracts, and is also conducted through contracts negotiated with any one of a number of commercial banks which comprise an informal market for such trading (bank forward contracts). Bank forward contracts differ from regulated futures contracts in that they are private contracts in which the parties remain entitled to performance from each other. They further differ from regulated futures contracts in that they do not call for daily variation margin to reflect market changes, and in that the interbank market has no mechanism for settlement terminating a taxpayer's position prior to the delivery date.[84]

To be subject to the mark to market provisions of ERTA, foreign currency contracts must be entered into at arm's length at a price determined by reference to the price in the interbank market.[85] A transaction resulting in a change in the parties to such a contract will be treated as a termination of the contract with respect to the original parties and the creation of a new contract with respect to the unchanged parties.[86] Such a new contract must qualify independently as a foreign currency contract in order to be eligible for treatment under the mark to market provisions.[87] The Technical Corrections Act authorizes the issuance of regulations

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[83] *See* Pub. L. No. 97-448, § 105(c)(5)(C), 96 Stat. 2365, 2386 (1983); I.R.C. § 1256(g)(1).

[84] H.R. Rep. No. 794, 97th Cong., 2d Sess. 23 (1982).

> Contracts traded in the interbank market generally include not only contracts between a commercial bank and another person but also contracts entered into with a futures commission merchant who is a participant in the interbank market. A contract between the two persons neither of whom is a futures commission merchant or other similar participant in the interbank market is not a foreign currency contract under the provision.

Conference Report, *supra* note 8, at H10702.

[85] *See* Conference Report, *supra* note 8, at H10702.

> In general, a price is determined by reference to the price in the interbank market if it is a price that would be obtainable from a bank that is a substantial participant in the interbank market. In making this determination, proper adjustments may be made for differences attributable to variations in the contracts customary in the interbank market, such as provisions relating to reasonable and customary commissions, the amount of currency under the contract, and the credit worthiness of the parties.

Id.

[86] *See id.*

[87] *See id.*

necessary or appropriate to carry out the purpose of new sections 1256(b) and 1256(g).[88]

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[88] *See id.*; Pub. L. No. 97-448, § 105(c)(5)(C), 96 Stat. 2365, 2386 (1983). "Thus, for example, terms which attempt to make the contracts transferable in such a way to allow them to be held as inventory (which would make them unlike futures contracts) could cause them to be ineligible for mark-to-market treament." Conference Report, *supra* note 8, at H10702.

In addition, a taxpayer who held foreign currency contracts during 1981 and before June 24, 1981 may elect to have the mark to market provisions apply to those contracts and may make a new election under either § 508(c) or § 509(a) of ERTA. *See id.*; Pub. L. No. 97-448, § 105(c)(5)(D)(ii)(II), 96 Stat. 2365, 2386 (1983). The elective provisions read as follows:

> (D) Effective Dates.-
>
> (i) In general.—Except as provided in clauses (ii) and (iii), the amendments made by subparagraphs (B) and (C) shall apply only with respect to contracts entered into after May 11, 1982.
>
> (ii) Election by taxpayer of retroactive application.—
>
> (I) Retroactive application.—If the taxpayer so elects, the amendments made by subparagraphs (B) and (C) shall apply as if included within the amendments made by title V of the Economic Recovery Tax Act of 1981.
>
> (II) Additional choices with respect to 1981.—If the taxpayer held a foreign currency contract after December 31, 1980, and before June 24, 1981, and such taxpayer makes an election under subclause (I), such taxpayer may revoke any election made under § 508(c) or 509(a) of such Act, and may make an election under § 508(c) or 509(a) of such Act.
>
> (III) Additional choices apply to all regulated futures contracts.—Except as provided in subclause (IV), in the case of any taxpayer who makes an election under subclause (I), any election under § 508(c) or 509(a) of such Act or any revocation of such an election shall apply to all regulated futures contracts (including foreign currency contracts).
>
> (IV) Section 509(a)(3) and (4) not to apply to foreign currency contracts.—Paragraphs (3) and (4) of § 509(a) of such Act shall not apply to any foreign currency contract.
>
> (V) Time for making election or revocation.—Any election under subclause (I) and any election or revocation under subclause (II) may be made only within the 90-day period beginning on the date of the enactment of this Act. Any such action, once taken, shall be irrevocable.
>
> (VI) Definitions.—For purposes of this clause, the terms "regulated futures contract" and "foreign currency contract" have the same respective meanings as when used in § 1256 of the Internal Revenue Code of 1954 (as amended by this Act).
>
> (iii) Election by taxpayer with respect to positions held during taxable years ending after May 11, 1982.—In lieu of the election under clause (ii), a taxpayer may elect to have the amendments made by subparagraphs (B) and (C) applied to all positions held in taxable years ending after May 11, 1982, except that the provisions of § 509(a)(3) and (4) of the Economic Recovery Tax Act of 1981 shall not apply.

Pub. L. No. 97-448, § 105(c)(5)(D), 96 Stat. 2365, 2386 (1983).

For an electing taxpayer, the election under § 508(c) or § 509(a) of ERTA must be applied to all RFCs and all foreign currency contracts. *See id.* § 105(c)(5)(D)(ii)(III), 96 Stat. at 2386 (1983).

The purpose of this amendment is to restore the comparable tax treatment of foreign currency RFCs and foreign currency bank forward contracts which was upset by ERTA, since the two types of contracts are economically interchangeable.[89] This special rule for bank forward contracts, which was urged by industry representatives,[90] extends RFC treatment to a type of contract that is not traded on a mark to market basis or even on an exchange. Thus, Congress is applying a constructive realization concept in a context that is substantially different from the application of the concept to standard RFCs. Indeed, as a policy matter, it is difficult to see why RFC treatment and the resultant thirty-two percent tax rate should be accorded to bank forward contracts, but not to other forms of investment instruments, such as stock options, debt options and commodity options, which are traded on an exchange but are not marked to market.[91] This point is developed further in

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[89] *See* H.R. Rep. No. 794, 97th Cong., 2d Sess. 23 (1982). The report further says:

> Prior to ERTA, taxpayers who used both the futures exchanges and the interbank market to conduct short term trading in foreign currency were subject to substantially comparable tax treatment for both types of contract. Although bank forward contracts differ from regulated futures contracts, the volume of trading through forward contracts in foreign currency in the interbank market is substantially greater than foreign currency trading on futures exchanges, and prices are readily available. Such contracts are economically comparable to regulated futures contracts in the same currencies and are used interchangeably with regulated futures contracts by traders.

Id.

[90] *See* Letter from Frank V. Battle, Jr. to Thomas Gallagher, Attorney-Advisor, Tax Legislative Counsel's Office (Dec. 8, 1981), *reprinted as* Tax Notes Documents No. 81-12076; Letter from Donald C. Lubick to Robert Woodward, Acting Associate Tax Legislative Counsel (July 12, 1982), *reprinted as* Tax Notes Documents No. 82-7832.

[91] Stock options are traded on the American Stock Exchange, Inc. (AMEX), the Chicago Board Options Exchange, Inc. (CBOE), the Philadelphia Stock Exchange, Inc. and the Pacific Stock Exchange, Inc. Legislation enacted in the last year settled the jurisdictional dispute between the CFTC and the SEC concerning the authority to regulate options and futures on debt securities by granting the SEC jurisdiction over options on debt instruments and the CFTC jurisdiction over futures on debt instruments. *See* Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (Jan. 11, 1983); Securities and Exchange Commission, Jurisdiction, Pub. L. No. 97-303, 96 Stat. 1409 (Oct. 13, 1982); H.R. Rep. No. 97-565, 97th Cong., 2d Sess., *reprinted in* 1982 U.S. Code Cong. & Ad. News 3871. As a result of this settlement, the AMEX and CBOE have begun trading put and call options on debt instruments. On October 1, 1982, various commodity exchanges, including the Chicago Board of Trade, began trading options on various commodity futures (i.e., commodity options).

For a comparison of the tax treatment of options on debt securities with the tax treatment of options on futures, see Letter and Supporting Memorandum from Joseph F. McDonald on behalf of the American Stock Exchange, Inc., Robert A. Rudnick and Linda Car-

Part V.

B. The Operation of the Mark to Market Rule

Section 1256(a)(1) provides that "each [RFC] held by the taxpayer at the close of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year (and any gain or loss shall be taken into account for the taxable year) . . . ."[92] Under this basic rule, open contracts are deemed to have been disposed of at the close of the taxable year. The rationale behind this rule, as previously noted, is to apply the concept of constructive receipt to gain in a futures trading account at year-end.[93] The Senate Finance Committee notes that the positive balance in a margin account which the futures trader may receive as a matter of right is comparable to interest accrued in a savings account but not withdrawn.[94]

A contract's "fair market value" will ordinarily be considered the same as the settlement price determined by the exchange for the futures contract on the last business day of the year.[95] Since the commission on a futures contracts is not due until the contract is closed, it is not clear whether the fair market value of the contract is to be reduced by the commission which would have been payable had the contract been closed out at year end or whether the commission is merely deferred until the contract is actually closed. The legislative history gives no indication of the proper answer to this question. However, temporary regulations issued by the Service

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lisle on behalf of the Philadelphia Stock Exchange, Inc., and Samuel C. Thompson, Jr. on behalf of the Chicago Board Options Exchange, Inc., to John E. Chapoton, Asst. Sec'y for Tax Policy (Aug. 19, 1982), *reprinted as* Tax Notes Documents No. 82-8962.

For a divergent opinion as to the preferable method of taxing options on commodity futures, see Letter and Supporting Memorandum from Donald Schapiro on behalf of the Coffee, Sugar and Cocoa Exchange, Inc. to John Chapoton (Sept. 29, 1982), *reprinted as* Tax Notes Documents No. 82-9883.

[92] I.R.C. § 1256(a)(1). Presumably under this rule, an RFC held by a decedent at the time of death would be marked to market in the decedent's final return.

[93] *See* notes 52-53 *supra* and accompanying text.

[94] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 157, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 256. The allowance of loss on open contracts is, however, not an application of the constructive receipt doctrine, but rather is the adoption of a constructive payment doctrine, a concept previously rejected by the courts. *See* Vander Poel v. Commissioner, 8 T.C. 407, 411-412 (1947).

[95] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 157, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 256.

take the position that the settlement price is to be determined without adjustment for anticipated commissions.[96]

The legislative history also offers no help in interpreting the provision in section 1256(a)(2) that a "proper adjustment" to income is to be made for gain or loss previously taken into account by the marking to market of open contracts in prior years.[97] The regulations will have to address this requirement in detail in order to prevent the occurrence of double deductions or double gain. Adjusting the taxpayer's basis in the RFC so that it is equal to the settlement price on the last day of the prior tax year appears to be a logical solution but will require a complex administrative scheme to cover all the possible permutations of such a system.[98]

Under section 1256(a)(3), any gain or loss with respect to any RFCs closed during the taxable year or left open at year end is treated as sixty percent long-term capital gain or loss and forty percent short-term capital gain or loss.[99] Since the maximum tax rate on individuals is now fifty percent, the maximum effective tax rate on an individual's income from RFCs is thirty-two percent.[100]

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[96] *See* Temporary Treas. Reg. § 5(c).1256-2(d). Temporary Treas. Reg. § 5(c).1256-2(d) states:

> (d) *Scope of election*—(1) *In general.* An election under this section applies to all regulated futures contracts subject to § 1256(a) held by the electing taxpayer during the taxable year which includes June 23, 1981. The election applies to a regulated futures contract only if the electing taxpayer is the person or entity that directly held the regulated futures contract during the taxable year. If a flowthrough entity, as described in § 1092(d)(3)(C), held regulated futures contracts during that taxable year, only the flowthrough entity may make an election under this section or under § 5c.1256-1 for those contracts. Even if the partnership makes neither election, the partner may not make either election for those contracts. The partner may, however, make either an election under this section or under § 5c.1256-1 (or neither election) for regulated futures contracts that the partner personally held during that taxable year, without regard to the election that the partnership made for the partnership property.
>
> (2) *Settlement price.* Gain or loss on contracts open at the end of the taxable year shall be determined by reference to the settlement price on the last business day of the taxable year, regardless of whether the settlement price was a limit move, and without adjustment for anticipated commissions.

Id.

[97] *See* I.R.C. § 1256(a)(2). Section 1256(a)(2) provides that "proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account by reason of paragraph (1)"(i.e. the mark to market rule). *Id.*

[98] *See* Shashy, *The Long and the Short of Straddles as a Tax Saving Device: New Law*, 40 N.Y.U. Inst. on Fed. Tax'n § 17.02(3).

[99] *See* Pub. L. No. 97-34, § 503(a), 95 Stat. 172, 327-28 (1981); I.R.C. § 1256(a)(3).

[100] Since an individual receives a deduction of 60% of his or her net capital gain (*see*

After ERTA, a taxpayer may elect to carry RFC losses back three years to offset prior RFC gains.[101] There is an unlimited carry forward of such losses.[102] Since the mark to market system began in 1981, that year is the earliest year to which RFC losses may be carried.[103]

For example, assume that a calender year taxpayer purchases ten silver futures contracts by depositing $2,000.[104] If the contracts appreciate in value to $2,500 by year's end, the taxpayer will be deemed to have a taxable gain of $500, sixty percent of which will be treated as long-term capital gain and forty percent as short-term. In contrast, if the contracts had dropped in value to $1,900 by December 31, the taxpayer would recognize a $100 loss. Of this loss, sixty percent would be long-term capital loss and forty percent would be short-term. If in the following year the taxpayer closes out for $2,800 the contracts that were marked to market at year end for $2,500, he will recognize a $300 capital gain, again taxed under section 1256(a)(3) as sixty percent long-term and forty percent short-term. If the value of these same contracts had dropped to $1600 at the time they were closed out, the taxpayer would realize a $900 capital loss, sixty percent of which would be long-term.

Futures contracts can be closed out either by making or taking delivery of the cash commodity or by making an opposite, or offsetting, futures transaction.[105] Section 1256(c) provides that con-

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I.R.C. § 1202(a)), the maximum tax on the long term capital gain portion of RFC income is 12% (*e.g.*, if an individual has $100 of gain from an RFC, 60% or $60 is treated as long-term capital gain, of which only 40% or $24 is taxed at a 50% maximum rate). The maximum tax on the short term capital gain portion is 20% (*e.g.*, the remaining 40% or $40 of gain from the RFC is treated as short-term capital gain, which is taxed at a 50% maximum rate), for a maximum aggregate tax of 32%. (This ignores the impact, if any, of the minimum tax.)

[101] *See* Pub. L. No. 97-34, § 504, 95 Stat. 172, 330-31 (1981); I.R.C. § 1212(c)(1).

[102] *See* I.R.C. § 1212(b).

[103] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 163, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 261.

[104] For the sake of simplicity, commission costs will be ignored.

[105] Only about 1% or 2% of futures contracts are actually consummated. *See* Hieronymus, *supra* note 9, at 31. Hieronymus describes the offsetting process as follows:

> Most futures contracts are offset by making opposite transactions. The owner of a futures contract to buy, say, December corn may elect at any time before he receives delivery to make a contract to sell December corn. He now both owns a contract to buy and a contract to sell which is a nonsense position. As the price goes up he makes on the one hand and loses on the other. Were the contracts to exist until maturity he would receive delivery from the person he made the purchase contract with at the

tracts terminated during the taxable year "by offsetting, by taking or making delivery, or otherwise" shall be treated in accordance with the rules that apply to open RFCs.[106] "Gain or loss upon termination is [to be] determined on the basis of the contract's fair market value at the time of termination, ordinarily the actual price received or paid."[107]

The Technical Corrections Act amended section 1256(c) to clarify that a "transfer" of a taxpayer's rights in an RFC is to be treated as a termination (i.e., a taxable event),[108] and gains and losses are to be taken into account as though the RFC was terminated by offset or delivery.[109] Therefore, transfers made to and from partnerships and other flowthrough entities are considered

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> agreed price and make delivery to the person with whom he made the contract to sell at the different agreed price, all of which would obviously be a cumbersome process and is not permitted. No person may hold both a contract to buy and a contract to sell the same maturity of the same commodity on the same exchange. As soon as the second transaction is made it is matched against the first and both are canceled and cease to exist. If the buying price of the original contract is lower than the selling price of the second contract a profit has been made and the trader receives money from the settlement system but if the price agreed in making the original contract is higher than the price agreed in the second transaction, the trader has lost and must pay money in. Contracts are settled by the payment of value differences when the contracts are offset.

Id. at 42.

[106] I.R.C. § 1256(c)(1).

[107] S. Rep. No. 144, 97th Cong., 1st Sess. 158, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 257.

[108] *See* Pub. L. No. 97-448, § 105(c)(1), 96 Stat. 2365, 2385 (1983); I.R.C. § 1256(c)(1).

[109] *See id. See also* H.R. Rep. No. 794, 97th Cong., 2d Sess. 23-24 (1982). Section 1256(c) now states:

> (c) Terminations, Etc.—
>
> (1) In general.— The rules of paragraphs (1),(2), and (3) of subsection (a) shall also apply to the termination (or transfer) during the taxable year of the taxpayer's obligation (or rights) with respect to a regulated futures contract by offsetting, by taking or making delivery, or otherwise.
>
> (2) Special rule where taxpayer takes delivery on part of straddle.—If—
>
> (A) 2 or more regulated futures contracts are part of a straddle (as defined in § 1092(c)), and
>
> (B) the taxpayer takes delivery under any of such contracts,
>
> then, for purposes of this section, each of the other such contracts shall be treated as terminated on the date on which the taxpayer took delivery.
>
> (3) Fair market value taken into account.—For purposes of this subsection, fair market value at the time of the termination (or transfer) shall be taken into account.

Pub. L. No. 97-448, § 105(c)(1), 96 Stat. 2365, 2385 (1983); I.R.C. § 1256(c).

terminations.[110] Presumably, a transfer of an RFC by gift also constitutes a termination under this amendment.[111]

The Technical Corrections Act also amended the termination rule to require that if a taxpayer holds a straddle that includes two or more RFCs, then all the contracts are to be treated as terminated on the date the taxpayer takes delivery on any of the contracts.[112] There would seem to be four basic situations that the regulations will have to address in dealing with the termination requirement: (a) closing out a long position by entering into an offsetting short position; (b) closing out a long position by taking delivery of the underlying cash commodity; (c) closing out a short position by entering into an offsetting long position; and (d) closing out a short position by delivering the underlying cash commodity. The treatment of each of these transactions is discussed below, together with a brief description of the tax treatment under prior law.[113]

The closing of a long RFC by offset was deemed to be a sale or exchange under prior law.[114] The taxpayer had capital gain or loss[115] unless the taxpayer came within the nonstatutory hedging exemption.[116] Because a long RFC qualifies for the special six month holding period under section 1222,[117] a taxpayer who had held a long RFC for the required six months would have had long-term capital gain or loss on the closing transaction. The short sale rules of section 1233 would have applied to treat any gain or loss as short-term where a long RFC was held for less than six months.[118] Under new section 1256, these basic rules appear to apply to the

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[110] *See* H.R. Rep. No. 794, 97th Cong., 2d Sess. 24 (1982).

[111] As indicated above, an RFC that is held by a decedent at the time of his death should be marked to market in the decedent's final return. *See* note 92 *supra*.

[112] *See* Pub. L. No. 97-448, § 105(c)(1), 96 Stat. 2365, 2385 (1983); I.R.C. § 1256(c)(2).

[113] For a more comprehensive discussion of how RFC terminations were treated before the enactment of ERTA, see Schapiro, *Tax Aspects of Commodity Futures Transactions*, *supra* note 9, §§ 16.04-.05.

[114] *See* Commissioner v. Covington, 120 F.2d 768 (5th Cir. 1941), *cert. denied*, 315 U.S. 822 (1942).

[115] *See* Faroll v. Jarecki, 231 F.2d 281 (7th Cir.), *cert. denied*, 352 U.S. 830 (1956).

[116] *See* Corn Products v. Commissioner, 350 U.S. 46 (1955); Rev. Rul. 72-179, 1972-1 C.B. 57. *Cf.* Rev. Rul. 78-414, 1978-2 C.B. 213 (T-bill RFCs purchased as investment do not qualify for hedging exemption). For a discussion of the hedging exemption under current law, see notes 271-88 *infra* and accompanying text.

[117] *See* I.R.C. § 1222, last sentence.

[118] *See id.* § 1233(a).

closing of a long RFC, except that the character of the gain or loss is now treated as sixty percent long-term and forty percent short-term capital gain or loss.[119]

Prior to ERTA, the closing of a long RFC by making payment of the purchase price and taking delivery of the cash commodity was not a recognition event.[120] Any gain inherent in the long futures contract was rolled into the cash commodity upon taking delivery,[121] and the holding period of the cash commodity included the holding period of the long RFC, provided that the long RFC was a capital asset.[122] Under new section 1256, the holder of a long RFC recognizes income or loss upon the taking of delivery of a cash commodity.[123] Thus, even though the taxpayer applies the credit balance in the margin account of his long RFC to the purchase price of the cash commodity, he must take the credit balance into income. The provision for tacking of the holding period under section 1223(8) no longer applies to the cash commodity acquired.[124] The Technical Corrections Act made the tacking rule of section 1223(8) inapplicable to a cash commodity acquired through the satisfaction of an RFC.[125] Also, as discussed above,[126] if a taxpayer holds two or more RFCs which are part of a straddle, and the taxpayer takes delivery under any of the RFCs which constitute part of such straddle, then all RFCs which are part of the straddle are treated as terminated on the day on which the taxpayer took delivery.[127]

The closing of a short RFC by offset under prior law always produced short-term capital gain or loss as a result of the short sale rule of section 1233(b).[128] Even though the short RFC might have been held for more than six months at the time of the acquisition

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[119] *See* Pub. L. No. 97-34, § 503(a), 95 Stat. 172, 327-28 (1981); I.R.C. § 1256(a)(3). *See also* note 99 *supra* and accompanying text.

[120] *See* Rev. Rul. 79-294, 1979-2 C.B. 305. *See also* Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279.

[121] *See* Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279.

[122] *See* I.R.C. § 1223(8) (prior to amendment by Pub. L. No. 97-448 (1983)).

[123] *See* I.R.C. § 1256(c). The character of that gain or loss is 60% long-term and 40% short-term capital gain or loss. *See* I.R.C. § 1256(a)(3). *See also* note 99 *supra* and accompanying text.

[124] *See* Pub. L. No. 97-448, § 105(c)(4), 96 Stat. 2365, 2385 (1983); I.R.C. § 1223(8).

[125] *See* Pub. L. No. 97-448, § 105(c)(4), 96 Stat. 2365, 2385 (1983).

[126] *See* note 112 *supra* and accompanying text.

[127] *See* I.R.C. § 1256(c)(2).

[128] *See id.* § 1233(b).

of the long, the holding period of the long RFC determined the nature of the capital gain or loss from the offset,[129] and the holding period of the offsetting long contract was suspended as long as the short RFC remained open.[130] ERTA turns the gain or loss on the offsetting transaction into sixty percent long-term and forty percent short-term capital gain or loss.[131]

The closing of a short RFC by making delivery of the cash commodity resulted under prior law in ordinary or capital gain or loss depending upon the character of the commodity delivered.[132] The gain or loss inherent in the contract was considered as gain or loss attributable to the property delivered.[133] Under new section 1256(a)(3), the gain or loss inherent in the short RFC with respect to which delivery is made is treated as sixty percent long-term and forty percent short-term capital gain or loss.[134] The character of any gain or loss inherent in the delivered cash commodity apparently will be determined by the character of that commodity in the taxpayer's hands.

The above examples demonstrate that the effect of the termination rule is to segregate any gain or loss that is inherent in an RFC from any gain or loss realized by the taxpayer in the underlying property.

C. Possible Applicability of the Disallowance of Loss and Capitalization of Carrying Charge Rules to Mixed Straddles

Section 1256(a)(4) provides that "if all the offsetting positions making up any straddle consist of regulated futures contracts . . . (and such straddle is not part of a larger straddle)," then the disal-

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[129] *See id.* The offsetting long contract is "substantially identical property" and was acquired by the taxpayer "after such short sale." *Id.*

[130] *See id.* § 1233(b)(2).

[131] *See* Pub. L. No. 97-34, § 503(a), 95 Stat. 172, 327-28 (1981); I.R.C. § 1256(a)(3). *See also* note 99 *supra* and accompanying text.

[132] *See* Schapiro, *Tax Aspects of Commodity Futures Transactions*, *supra* note 9, at 16-13.

[133] For example, the holder of a short T-bill RFC with respect to which there was a loss could close out the transaction with ordinary loss treatment by purchasing T-bills (which were not capital assets) and making delivery. If, however, he had closed out his position by entering into an offsetting long RFC, his loss would have been a short-term capital loss. *See id.* at 16-15.

[134] *See* I.R.C. § 1256(a)(3). *See also* note 99 *supra* and accompanying text.

lowance of loss rule of section 1092[135] and the capitalization of carrying costs rule of section 263(g)[136] will not apply to such straddle.[137] However, if a taxpayer enters into a straddle involving an RFC and a non-RFC, both of these provisions will apply to both the RFC and the non-RFC. In addition, section 1256 will apply to the RFC unless the taxpayer elects to have such straddle identified as a "mixed straddle"[138] in accordance with the rules of section 1256(d).[139] If the taxpayer identifies such a straddle as a "mixed straddle," section 1256 will not apply to the RFC.[140]

A mixed straddle is defined as any straddle:

> (A) at least 1 (but not all) of the positions of which are regulated futures contracts, and
> (B) with respect to which each position forming part of such strad-

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[135] For a discussion of the disallowance of loss rule, see notes 172-95 *infra* and accompanying text.

[136] For a discussion of the capitalization of carrying costs rule, see notes 263-70 *infra* and accompanying text.

[137] I.R.C. § 1256(a)(4). For a definition of the term "straddle," see notes 147-71 *infra* and accompanying text.

[138] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 158-59, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 257-258. The Senate Finance Committee Report explains the treatment of unidentified mixed straddles:

> If a taxpayer fails to identify the positions constituting a mixed straddle, or, if a taxpayer fails to make an election of a consistent tax treatment for all the positions in such a straddle, the amount of any gain or loss on futures contracts in the straddle is determined under the mark-to-market rules. Gain or loss on other positions in the straddle is determined under the regular tax rules. All poisitions [sic] in the straddle, both futures contracts and other property, are subject to the loss deferral rule in § 1092, the modifications of the wash sale and short sale rules applicable to straddles, and the capitalization rule in § 263(g). The application of § 1092 to such unidentified mixed straddles will result in the deferral of all losses with respect to which there is offsetting unrealized gain, so that losses realized on the mark-to-market system are deferred to the extent there are unrealized gains in other property. Similarly, losses on property outside the mark-to-market system are deductible to the extent of gains on futures contracts in the mark-to-market system (provided there are no unrealized gains in other offsetting positions.)

Id.

[139] *See* I.R.C. § 1256(d). The identified mixed straddle provision originated in the Senate Finance Committee, but the Senate provision allowed the taxpayer to elect either to treat both positions on a mark to market basis or to exclude both from the mark to market treatment. *See* S. Rep. No. 144, 97th Cong., 1st Sess. 158, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 257. The enacted version only allows for an election out of the mark to market rule. The Joint Committee report on the final bill states clearly that "[a] taxpayer may not elect to bring any positions that are not regulated futures contracts onto the mark-to-market rules." General Explanation, *supra* note 58, at 298.

[140] *See* I.R.C. § 1256(d)(1).

> dle is clearly identified, before the close of the day on which the first regulated futures contract forming part of the straddle is acquired, as being part of such straddle.[141]

As an example, consider a taxpayer who on the same day buys a Treasury Bill RFC (a long position) and acquires an offsetting Treasury Bill put option (a short position). If, before the close of the day, the taxpayer identifies both positions as being part of a mixed straddle, the T-bill RFC would not be subject to the mark to market rule of section 1256.[142] Instead, both positions would be subject only to the loss disallowance rule of section 1092 and the capitalization of carrying costs rule of section 263(g).[143] An election under section 1256(d) applies to the taxable year for which it was made and to all subsequent years, unless the Secretary consents to a revocation.[144]

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[141] I.R.C. § 1256(d)(4). Prior to amendment by § 105(c)(2) of the 1982 Technical Correction Act, § 1256(d)(4)(B) read:

> (B) with respect to which each position forming part of such straddle is clearly identified, before the close of the day on which such position is acquired, as being part of such straddle.

I.R.C. § 1256(d)(4)(B) (prior to amendment by Pub. L. No. 97-448 (1983)).

According to both the Technical Corrections House Report and the Technical Corrections Senate Report, the section was amended to clarify "that an election as to whether § 1256 will apply to a regulated futures contract included in a mixed straddle may not be deferred beyond the date [on which] that contract is acquired." H.R. Rep. No. 794, 97th Cong., 2d. Sess. 24 (1982); S. Rep. No. 592, 97th Cong., 2d Sess. 27 (1982). The Reports explain that for the above purpose, when a short RFC is terminated under § 1256(c)(2) by a taxpayer taking delivery under a long RFC, the short position is treated as a new regulated futures contract acquired on that date. *See* H.R. Rep. No. 794, 97th Cong., 2d Sess. 24 (1982); S. Rep. No. 592, 97th Cong., 2d Sess. 27 (1982).

[142] *See* I.R.C. § 1256(d)(1). Assume a taxpayer holds a long Treasury bill future with respect to which there is $100 of unrecognized gain and owns a Treasury bill put option (a short position) with respect to which there is a $95 loss. Assume further that at the time the taxpayer acquired the positions he did not identify the straddle as a mixed straddle. The taxpayer continues to hold both positions at year end and both positions maintain their above stated values. Section 1256 will force recognition of the $100 gain in the long Treasury bill future but the taxpayer will not receive any corresponding loss from the Treasury bill put option. If, however, the mixed straddle election is made, the taxpayer does not have recognition at year end with respect to the Treasury bill future. *See* text accompanying notes 175 and 180-81 *infra* for two examples of the general operation of § 1092.

[143] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 158, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 257.

[144] *See* I.R.C. § 1256(d)(3). The election is to be made at the time and in the manner specified in regulations. *See id.* § 1256(d)(2).

III. Tax Treatment of Non-Regulated Futures Contracts

New section 1092 governs the tax treatment of non-RFC straddles.[145] The rules under this provision purport to "prevent deferral of income and conversion of ordinary income and short term capital gains into long term capital gains"[146] through the loss disallowance rule and the application of short sale and wash sale principles to non-RFC straddles.

The key to determining if section 1092 applies is to ascertain whether the taxpayer has entered into a non-RFC straddle. After a discussion of the term "straddle," this part of the article explores the operation of the disallowance of loss rule and the concept of "identified straddles." The related wash sale and short sale rules are examined next. Finally, this part discusses the special exemption for exchange-traded stock options.

A. *Straddles Defined*

Because section 1092(c)(1) defines a straddle as "*offsetting positions* with respect to *personal property*,"[147] the meaning of these terms is essential to understanding the operation of the provision. Personal property is defined in section 1092(d)(1) as "any personal property (other than stock) of a type which is actively traded."[148] Thus, personal property includes debt instruments, various grains, various metals and various currencies, but probably does not include items such as works of art. The Treasury should undertake to add some content to the "actively traded" concept since the committee reports do not indicate what this term means.

Section 1092(d)(2)(A) defines a position as "an interest (including a futures or forward contract or option) in personal property."[149] Thus, for example, a forward contract on silver or an option on debt instruments, such as Treasury Bills or GNMA certificates, would be a position in personal property. Although a futures contract is a position for purposes of section 1092(d)(2)(A),

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[145] *See* Pub. L. No. 97-34, § 501(a), 95 Stat. 172, 323 (1981); I.R.C. § 1092. The provision does not apply to hedging transactions. *See* I.R.C. § 1092(e). For a discussion of the hedging exemption, see notes 271-88 *infra* and accompanying text.

[146] General Explanation, *supra* note 58, at 283.

[147] I.R.C. § 1092(c)(1) (emphasis added).

[148] *Id.* § 1092(d)(1).

[149] *Id.* § 1092(d)(2)(A).

RFCs in general are subject to the mark to market rule of section 1256 and thus are not subject to section 1092.[150] As will be seen in Part III-F below, there is a special exemption from section 1092 for exchange-traded stock options.[151]

Section 1092(d)(3) contains an attribution rule which treats positions held by a "related person" or a "flowthrough entity" of which the taxpayer is an owner as being positions held by the taxpayer.[152] A "related person" is defined to mean the taxpayer's spouse or a corporation which files a consolidated return with the taxpayer under section 1501.[153] "Flowthrough entities" include trusts, partnerships and subchapter S corporations.[154]

Although the meanings of "position" and of "personal property" are necessary factors in understanding the application of section 1092, the key element is determining whether the taxpayer holds any positions in personal property which offset each other. Generally, 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 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)."[155] The Senate Finance Committee Report elaborates on the substantial diminution concept by noting that although the concept is not "narrowly defined," a "mere diversification of positions" would not substantially reduce risk as long as the positions are not "balanced."[156] Beyond this, the legislative history does not give any meaningful guidance as to the intended ap-

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[150] *See id.* § 1256(a)(4).

[151] *See* I.R.C. § 1092(d)(2)(B). *See also* notes 236-59 *infra* and accompanying text.

[152] *See* I.R.C. § 1092(d)(3).

[153] *See id.* § 1092(d)(3)(B).

[154] *See id.* § 1092(d)(3)(C). The Senate Finance Committee Report says:

> If part or all of the gain or loss from a position held by a flow-through entity would be properly taken into account in determining the taxpayer's own Federal tax liability, the position is treated as held by the taxpayer, unless the regulations provide otherwise.

S. Rep. No. 144, 97th Cong., 1st Sess. 151, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 250-51.

[155] I.R.C. § 1092(c)(2).

[156] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 150, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 249-50. A straddle may consist of two futures contracts in silver or of a cash position in silver (holding the physical commodity itself) and a short futures contract in silver. *See id. See also* General Explanation, *supra* note 58, at 288.

plication of the terms "substantial diminution" and "risk of loss."

The meaning of "substantial diminution" will of course turn on what is considered to be "substantial." In another context, the Service has ruled that a "substantial part" means one third of a whole.[157] Applying this concept here would mean that a taxpayer would be in an offsetting position if, as a result of holding one position, his risk of loss in holding another is reduced by one third.

This, of course, leads to the question of what is the taxpayer's risk of loss. As a theoretical matter, a taxpayer's risk of loss from holding property is equal to the fair market value of the property at any given time, but as a practical matter the risk of loss may be much less than the fair market value because the value of the property is unlikely to drop to zero. The statute, however, merely says "risk of loss" which would seem to mean the theoretical limits of the taxpayer's risk of loss (i.e., the fair market value at any given point in time).

Putting these concepts together, a taxpayer would appear to be in offsetting positions if as a result of holding one position (e.g., a short gold forward contract) the risk of loss of holding another (e.g., an ounce of gold) is reduced by at least a third of the fair market value of the gold. It should be clear from the foregoing discussion that considerable ambiguity surrounds the meaning of the critical term "offsetting position."[158] Ideally, the scope of this concept will be addressed promptly in regulations.

Congress does set forth certain circumstances in which positions are presumed to be offsetting.[159] These presumptions are rebuttable,[160] but neither the statute nor the committee reports explain how this may be accomplished. It would appear that the taxpayer would have to establish to the satisfaction of the Service that the positions were not offsetting.

Positions in the "same personal property (whether established in such property or a contract for such property) . . . even though

[157] *See* Rev. Rul. 72-48, 1972-1 C.B. 102 (defining the meaning of a "substantial part" of taxable income in the context of the definition of a collapsible corporation, I.R.C. § 341(b)(1)(A)).

[158] For a critical discussion of the problems that may arise as a result of this ambiguity, see House Hearing, *supra* note 2, at 202 (testimony of Donald Schapiro) and at 308-11 (statement of Barnett, Alagia & Carey).

[159] *See* I.R.C. § 1092(c)(3)(A).

[160] *See id.* § 1092(c)(3)(B).

such property may be in a substantially altered form,"[161] are presumed to be offsetting, provided the value of one or more such positions ordinarily varies inversely with the value of one or more other such positions.[162] As an example, a taxpayer who is long in cash silver and short in silver futures contracts, or is long in soybeans and short in soybean meal is in offsetting positions because the value of such positions ordinarily vary inversely.[163]

Positions are also presumed to be offsetting if "the positions are sold or marketed as offsetting positions (whether or not such positions are called a straddle, spread, butterfly or any similar name)."[164] Likewise, positions are presumed to be offsetting if their aggregate margin requirement is lower than the sum of the margin requirements for each position held separately.[165] For example, the positions in Revenue Ruling 77-185 would be presumed to be offsetting, because, *inter alia*, the aggregate margin required to hold those positions was less than the sum of the margin requirements for the separate positions.[166]

Also presumed to be offsetting are positions in debt instruments provided the debt intruments are of a similar maturity (or are as described in the regulations) and the value of such positions ordinarily varies inversely.[167] For example, a taxpayer who holds a GNMA certificate and is short a treasury bond future may be in an offsetting position if, as the value of the GNMA goes up, the value of the future usually goes down and vice versa. Finally, positions

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[161] *Id.* § 1092(c)(3)(A)(i)-(ii).

[162] *See id.* § 1092(c)(3)(A), last sentence.

[163] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 150, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 249-50.

[164] I.R.C. § 1092(c)(3)(A)(iv).

[165] *See id.* § 1092(c)(3)(A)(v). The Senate Finance Committe Report explains:

> Thus, if the value or amount of the deposit, pledge, payment, security, or other requirement for holding two or more positions together ordinarily is less than the cost of holding each alone, this presumption applies. Generally, the lower margin for the aggregate holdings is evidence that there is less economic risk associated with holding the combined positions than with holding each of the positions separately.

S. Rep. No. 144, 97th Cong., 1st Sess. 150, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 249-50.

[166] *See* Rev. Rul. 77-185, 1977-1 C.B. 49.

[167] *See* I.R.C. § 1092(c)(3)(A)(iii). According to the Joint Committee report, "[g]enerally, debt instruments are considered to be of a similar maturity if the scheduled maturities are in sufficiently close proximity to each other that a change in value of one instrument will correspond substantially to a change in value of the other." General Explanation, *supra* note 58, at 288.

are presumed to be offsetting if "there are such other factors (or satisfaction of subjective or objective tests) as the Secretary may by regulations prescribe as indicating that such positions are offsetting,"[168] provided, however, the value of such positions ordinarily varies inversely.[169]

One final rule on offsetting positions is set forth in section 1092(c)(2)(B).[170] The Secretary is to promulgate regulations for the purpose of determining what portion of a position is to be taken into account under section 1092 where one or more positions offset only a portion of one or more other positions.[171] Thus, if a taxpayer buys one silver forward contract and simultaneously sells several other silver forward contracts, the regulations are to specify which or what portion of the several contracts to sell offset the one contract to buy. Obviously, this could become a regulatory nightmare.

The definitions of the terms "straddle" and "offsetting positions" are quite broad and are obviously written in such a way as to give the Service a powerful weapon for challenging any scheme that might be devised to defeat the purpose of section 1092. Unfortunately, the breadth of the definition may also encompass legitimate, profit-seeking transactions which have no tax avoidance purpose.

B. *The Disallowance of Loss Rule*

The general disallowance of loss rule limits the recognition of loss incurred on the disposition of one leg of a straddle to an amount equal to the excess of the loss from the disposed leg over any unrecognized gain on the other leg.[172] Therefore, where the amount of the loss is equal to or less than the unrecognized gain, the loss will not be allowed. The section does not force recognition of unrealized gain as does section 1256.

The Technical Corrections Act contains a provision that clarifies that the loss deferral rule applies to "unrecognized" gain rather

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[168] I.R.C. § 1092(c)(3)(a)(vi). This authority will enable the Secretary "to develop presumptions which treat complex or innovative types of straddles as offsetting positions." S. Rep. No. 144, 97th Cong., 1st Sess. 150, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 249-50.

[169] *See* I.R.C. § 1092(c)(3), last sentence.

[170] *See id.* § 1092(c)(2)(B).

[171] *See id.*

[172] *See id.* § 1092(a)(1)(A).

than to "unrealized" gain.[173] The purpose of this provision is to prevent a cash basis taxpayer from closing out both positions of a non-RFC straddle at year-end and claiming the loss in the year of the closing, but claiming the gain in the following year when the proceeds are received.[174]

If a taxpayer enters into a straddle consisting of a long silver forward contract and a short silver forward contract and later disposes of the short contract at a loss of $100, section 1092(a) limits recognition of that $100 loss to the excess of the $100 over the unrecognized gain in the long silver forward contract.[175] If the unrecognized gain were $90, the taxpayer could claim a $10 loss; if the unrecognized gain were $110, the taxpayer would not be permitted to claim a loss.

This provision applies where the gain position or positions were *offsetting positions* with respect to the position or positions from which the loss arose.[176] The Technical Corrections Act removed the requirement that the gain position or positions be acquired before the disposition of the loss position or positions.[177] The key determination is now whether the gain position and the loss position are offsetting. There is no indication from the statute as to whether the positions must have been offsetting positions at the time they

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[173] *See* H.R. Rep. No. 794, *supra* note 141, at 22; S. Rep. No. 592, *supra* note 141, at 25. Section 1092(a)(1)(A), as amended, now states:

> (A) In General—Any loss with respect to 1 or more positions shall be taken into account for any taxable year only to the extent that the amount of such loss exceeds the unrecognized gain (if any) with respect to 1 or more positions which were offsetting positions with respect to 1 or more positions from which the loss arose.

See Pub. L. No. 97-448, § 105(a)(1)(A), (a)(2), 96 Stat. 2365, 2384 (1983); I.R.C. § 1092(a)(1)(A).

[174] *See* H.R. Rep. No. 794, *supra* note 141, at 22; S. Rep. No. 592, *supra* note 141, at 25. This deferral opportunity was available because,

> [u]nder tax accounting rules, gains from sales of property by a taxpayer on the cash method of accounting are not taken into account until the sale proceeds are actually or constructively received. In the case of year-end sales, consummation of the sales contract and receipt of the sales proceeds may not take place until the following year. Losses, however, are generally taken into account for tax purposes on the date the sales contract is executed.

Id.

[175] *See* I.R.C. § 1092(a)(1)(A).

[176] *See id.*

[177] *See* Pub. L. No. 97-448, § 105(a)(2), 96 Stat. 2365, 2384 (1983) (deleting I.R.C. § 1092(a)(1)(A)(i) & (iii)).

were acquired.[178]

The taxpayer need not be in offsetting positions at the end of the tax year for section 1092 to apply.[179] Rather, he need only hold a position with respect to which there is unrecognized gain at the end of the tax year and which previously offset a position that had been disposed of at a loss.[180] For example, assume that in June a calendar year taxpayer is long a Treasury bill with respect to which there is $100 of unrecognized gain and short a Treasury bill future (i.e., the taxpayer has entered into a contract to sell) with respect to which there is a $95 loss. Assume further that the two positions were acquired at the same time. The taxpayer closes out the future, realizing the $95 loss, but he continues to hold the Treasury bill, which on December 31 shows an unrecognized gain of $80. In such a case the taxpayer would be allowed a $15 loss for the tax year. If, on the other hand, the Treasury bill at year end had an unrecognized gain of $98 for instance, the taxpayer would not be allowed a loss deduction for the year. In the latter example, the taxpayer would not recognize the net unrecognized gain of $3.

Unrecognized gain in the case of any position held by a taxpayer as of the close of the taxable year is defined as 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."[181] "[I]n the case of any position with

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[178] It appears to be possible that positions which were not offsetting at the time acquired could become offsetting at a later point and brought within § 1092. However, this would probably be a rare situation.

[179] Note that the general disallowance of loss rule was drafted without specific reference to straddles. *See* I.R.C. § 1092(a)(1).

[180] *See* I.R.C. § 1092(a).

[181] I.R.C. § 1092(a)(3)(A). The Technical Corrections Act changed the definition of unrealized gain to a definition of unrecognized gain to conform to the amendments to § 1092(a)(1)(A). *See* Pub. L. No. 97-448, § 105(a)(1)(B), 96 Stat. 2365, 2384 (1983). The new wording of § 1092(a)(3)(A) is as follows:

> (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.

Id.; I.R.C. § 1092(a)(3)(A).

respect to which, as of the close of the taxable year, gain has been realized but not recognized," unrecognized gain means "the amount of gain so realized."[182]

At the end of the taxable year, each taxpayer is required to disclose all of his open positions that show a gain, and the amount of each unrecognized gain.[183] This disclosure permits the taxpayer and the auditing agent to compare the closed positions with respect to which the taxpayer has realized losses with the open gain positions and determine whether any of the open gain positions offset any of the closed loss positions.[184] A taxpayer is not required to disclose any position that is part of an identified straddle,[185] that is an ordinary income item,[186] or that is part of a hedging transaction.[187] Also, no disclosure is required for any taxable year in which either no loss on a position has been sustained or the only losses in such year were ordinary losses.[188]

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[182] I.R.C. § 1092(a)(3)(A)(ii).

[183] *See id.* § 1092(a)(3)(B)(i)(I)-(II). The Technical Corrections Act amended § 1092(a)(3)(B)(i)(I)-(II) to state:

> (I) each position (whether or not part of a straddle) with respect to which, as of the close of the taxable year, there is unrecognized gain, and
>
> (II) the amount of such unrecognized gain.

Pub. L. No. 97-448, § 105(a)(1)(C), 96 Stat. 2365, 2384 (1983); I.R.C. § 1092(a)(3)(B)(i)(I)-(II).

[184] "The Secretary is authorized to issue regulations prescribing the time, manner and form required for disclosure of such unrecognized gains on taxpayers' annual tax returns." S. Rep. No. 144, 97th Cong., 1st Sess. 148, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 247-48. *See* I.R.C. § 1092(a)(3)(B)(i). The information is to be provided on Form 6781. *See* New Form 6781, 14 Tax Notes (Tax Analysts) No. 7, at 411 (Feb. 15, 1982) (press release issued by the Service on Feb. 10, 1982).

[185] *See* I.R.C. § 1092(a)(3)(B)(ii)(I). *See also* notes 196-206 *infra* and accompanying text. "The exceptions available for identified straddles effectively will make such disclosure elective for most taxpayers." S. Rep. No. 144, 97th Cong., 1st Sess. 148, *reprinted* in 1981 U.S. Code Cong. & Ad. News 105, 248.

[186] *See* I.R.C. § 1092(a)(3)(B)(ii)(II). An ordinary income item is defined by either paragraph (1) or (2) of § 1221. *See id.*

[187] *See id.* For a discussion of hedging transactions, see notes 271-88 *infra* and accompanying text.

[188] *See* I.R.C. § 1092(a)(3)(B)(ii)(III). A position for this purpose includes an RFC. *See id.* The Joint Committee report says:

> Taxpayers will not be required to file disclosure reports on unrealized gains if they have sustained no loss on any position (including regulated futures contracts) during the taxable year, or if the only loss sustained was a loss on inventory or depreciable trade or business property described in paragraph (1) or (2), respectively, of § 1221. No disclosure report is required for any positions which are part of an identified straddle. Further, taxpayers who sustain losses from the disposition of long positions

If the taxpayer fails to report his unrecognized gains[189] and the taxpayer has an underpayment of tax attributable to the disallowance of the loss, then the underpayment shall be treated as "due to negligence or intentional disregard of the rules and regulations."[190] Such an underpayment is subject to a penalty equal to five percent of its value.[191] This penalty is levied even if the failure to report is due to the taxpayer's reliance on counsel's opinion that the gain position did not offset the loss.[192] The intent of this strict rule is clearly to promote full disclosure. The taxpayer may rely on the opinion of counsel to claim a loss deduction, but in order to avoid the penalty, he must disclose all of his unrecognized gain positions and indicate that none are considered offsetting.[193]

Any loss that is disallowed for a tax year is treated as though sustained in the succeeding tax year unless again disallowed under the general disallowance rule of section 1092(a)(1).[194] The Senate Finance Committee explains:

> Deferred losses are recognized in the first taxable year in which there is no unrealized appreciation in offsetting positions acquired before the disposition of the loss position. If there is more than one position with unrealized gain which was acquired prior to the loss disposition, which offsets the loss position and which does not belong to an identified straddle, the bill authorizes the Secretary of the Treasury to prescribe regulations for allocating loss among the unrealized gain in such positions and for allocating unrealized gain among loss positions.[195]

> and who have neither disposed of nor hold any short positions, whether as options, regulated futures contracts, forward sales, or otherwise, generally would not hold offsetting positions and would not be expected to report unrealized gain.

General Explanation, *supra* note 58, at 286.

[189] The report is to be filed on Form 6781. *See* note 184 *supra*.

[190] I.R.C. § 6653(f). If such failure is due to a reasonable cause, § 6653 will not apply. *See* I.R.C. § 6653(f)(1). Section 6653(f) was amended to redesignate subsection (g) as subsection (f). *See* Pub. L. No. 97-448, § 105(a)(1)(D)(i), 96 Stat. 2365, 2384 (1983). The heading of new subsection 6653(f) was also amended by replacing "Unrealized" with "Unrecognized." *See id.* § 105(a)(1)(D)(ii), 96 Stat. 2365, 2384 (1983).

[191] *See* I.R.C. § 6653(a).

[192] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 152, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 251.

[193] *See id.*

[194] *See* I.R.C. § 1092(a)(1)(B).

[195] S. Rep. No. 144, 97th Cong., 1st Sess. 147, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 246-47. The Senate Report continues:

> The committee intends that allocation of unrealized gain positions to unrealized

C. *Identified Straddles*

A taxpayer can choose not to have the disallowance of loss rule apply to certain straddles if he designates them as identified straddles.[196] In order for a straddle to qualify as an identified straddle, it must meet the following four conditions: (1) it must be clearly identified as such in the taxpayer's records before the close of the day on which it was acquired;[197] (2) all of the original positions which comprise it must be acquired on the same day;[198] (3) all of the positions must be disposed of on the same day during the taxable year or must all still be open at the end of the taxable year;[199] and (4) it cannot be part of a larger straddle.[200] Any loss with respect to an identified straddle is treated as "sustained not earlier than the day on which all the positions making up the straddle are disposed of."[201] Thus, in the case of an identified straddle there will be a matching of realization on the loss leg with realization on the gain leg.[202]

The principal advantage of the identified straddle provision is that the taxpayer can segregate his straddle transactions from his non-straddle transactions and need not report his unrecognized gains on the positions in his identified straddles.[203] Although the taxpayer will have to report the unrecognized gains on his non-identified straddle positions, he will have to be concerned only that such positions may offset one or more non-identified straddle positions for which he has taken a loss. Such positions will not offset

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> losses be done in a consistent manner that does not distort income. Regulations issued under this bill should provide that one dollar of unrealized appreciation at the end of any year defer at most only one dollar of realized loss.

Id. at 147-48, *reprinted in* 1981 U.S. Code Cong. & Ad. News at 246-48. The Senate Report's references to "unrealized" gain or appreciation, written in 1981, would now apply to "unrecognized" gain or appreciation. *See* notes 173-74 *supra* and accompanying text.

[196] *See* I.R.C. § 1092(a)(2)(A)(i).

[197] *See id.* § 1092(a)(2)(B)(i).

[198] *See id.* § 1092(a)(2)(B)(ii).

[199] *See id.* § 1092(a)(2)(B)(ii)(I)-(II).

[200] *See id.* § 1092(a)(2)(B)(iii). A larger straddle would be, for example, a butterfly straddle.

[201] *Id.* § 1092(a)(2)(A)(ii). This provision appears to be a tautology because, in order to qualify as an identified straddle, all the positions must be disposed of on the same day. *See id.* § 1092(a)(2)(B)(ii)(I).

[202] *See id.* § 1092(a)(2)(A)(ii).

[203] *See id.* § 1092(a)(3)(B)(ii)(I).

any identified straddle positions.[204]

If a taxpayer initially designates a straddle as an identified straddle and disposes of the loss leg while retaining the gain leg, the taxpayer would have to disclose the unrecognized gain and the loss would be allowed only to the extent it exceeded such gain. This results because the straddle would no longer be an identified straddle[205] and, therefore, would become subject to the provisions requiring disclosure of unrecognized gain.[206]

D. The New Wash Sale Rule

Another weapon given to the Service by ERTA to help it combat tax deferral through straddles is found in section 1092(b).[207] This section authorizes the Secretary to promulgate regulations that will apply rules similar to the wash sale rule of section 1091 to gain or loss with respect to any position of a straddle.[208] In examining this provision, it is first necessary to discuss the operation and effect of the wash sale rule under section 1091.

Section 1091(a) prohibits a loss deduction resulting from the disposition of stock or securities if the taxpayer acquires (or enters into a contract or option to acquire) stock or securities substantially identical to those disposed within thirty days before or after the loss sale.[209] A basis adjustment is made to the newly acquired stock or security in order to properly reflect the disallowed loss.[210] The purpose of the wash sale rule is to disallow losses that are not true economic losses because of the taxpayer's continued investment in the loss property.[211] Under prior law, commodity futures

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[204] *See id.* § 1092(c)(2)(C). Section 1092(c)(2)(C) provides that if a position is not part of an identified straddle, then it will not be treated as offsetting any position that is part of an identified straddle. *See id.* The Technical Corrections Act amended § 1092(c)(2)(C) by striking "subsection (a)(3)(B)" and inserting in its place "subsection (a)(2)(B)." The amendment was merely clerical. *See* Pub. L. No. 97-448, § 105(a)(4), 96 Stat. 2365, 2385 (1983); I.R.C. § 1092(c)(2)(C).

[205] *See* I.R.C. § 1092(a)(2)(B)(ii)(I).

[206] *See id.* § 1092(a)(3)(B).

[207] *See id.* § 1092(b).

[208] *See id.*

[209] *See id.* § 1091(a). The prohibition, therefore, covers a period of 61 days. The § 1091 disallowance of loss rule does not apply to sales made by an individual in connection with his trade or business or by a corporation that is a dealer in stock or securities in the ordinary course of its business as a dealer. *See* Treas. Reg. § 1.1091-1(a).

[210] *See* I.R.C. § 1091(d).

[211] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 143, *reprinted in* 1981 U.S. Code Cong. &

were not subject to the wash sale rule because such contracts are not stock or securities.[212]

By enacting section 1092(b), Congress substantially expanded the coverage of the wash sale rule in two respects. First, the wash sale rule will now apply to interests in "personal property" as defined in section 1092(d)(1).[213] Thus, the wash sale treatment is extended far beyond stock and securities. Second, since the section 1092 provision applies to "straddles," the concept of "offsetting position" is substituted for the concept of "substantially identical property."[214] The "offsetting position" concept, based on the principle of substantial diminution of risk, is much broader than that of "substantially identical property." For example, the new wash sale rule would apply where a futures contract which was part of a mixed straddle was disposed of at a loss, and a forward contract was acquired as a replacement leg within thirty days.[215] Although the forward contract may not be "substantially identical" to the futures contract because it requires delivery in a different month,[216] the loss on the futures contract will be deferred under section 1092(b) because the contracts perform the same function in the straddle. They both substantially diminish the risk of loss from holding the other leg of the straddle. If the wash sale rule had applied to the silver straddle in Revenue Ruling 77-185,[217] the taxpayer's loss in the first year would have been disallowed because he reestablished an offsetting position on the day he closed out his loss leg.

Arguably section 1092(a) would disallow every loss that the application of the wash sale rule to straddles disallows. However, the

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Ad. News 105, 242. Section 1091 is meant to prevent a taxpayer "from selling stock which has declined in value in order to establish a loss for tax purposes and immediately reacquiring similar stock, because the sale and reacquisition together do not significantly alter the taxpayer's position with respect to that stock." *Id.*

[212] *See* Rev. Rul. 71-568, 1971-2 C.B. 312. The effect of this Revenue Ruling has now been legislatively overruled. *See* text accompanying note 213 *infra.*

[213] *See* I.R.C. § 1092.

[214] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 150, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 249-50. In situations where both the new regulations and present law appear to apply, the application of the new regulatory rules under §§ 1091 and 1233 is to supercede any present law applications of those sections. *See id.*

[215] Presumably, the new regulations under § 1092(b) will retain the 61 day wash sale period.

[216] *See* I.R.C. § 1233(e)(2)(B).

[217] *See* notes 10-22 *supra* and accompanying text.

Senate Finance Committee Report says that the wash sale rule applies independently of and prior to the general disallowance of loss rule.[218] Thus, the wash sale rule takes precedence whenever a taxpayer disposes of a loss leg and acquires a replacement leg within the sixty-one day period. If a replacement leg is not acquired within the sixty-one day period, then the loss disallowance rule of section 1092 may apply. Section 1092(a), of course, covers more transactions than the wash sale rule. For example, it applies when the loss leg of a reconstituted straddle is disposed of without replacing that leg within the sixty-one day period,[219] and it covers the situation in which the taxpayer disposes of the loss leg and never replaces it.

E. The New Short Sale Rule

Section 1092(b) also authorizes the Secretary to promulgate regulations to extend the short sale rules of section 1233(b) and (d) to straddles.[220] A short sale is a contract made to deliver property at a specified price at a future date.[221] The seller may or may not own the property promised for delivery at the time the short sale is made. In the absence of section 1233, taxpayers could use short sales to "lock in" the gain on a capital asset before the long-term capital gain holding period had run, thereby enabling them to obtain preferential tax treatment in situations where they were not exposed to the risk of holding the property for the requisite long-term period.[222]

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[218] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 150, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 249-50.

[219] The Senate Finance Committee Report states that in the typical tax-shelter straddle transaction,

> the modified wash-sale rule will prevent deduction of the loss. Thus, the loss deferral rule of § 1092 does not apply to this loss because § 1092 defers losses only if they are otherwise allowable. Any loss subsequently sustained on either leg of the reconstituted straddle may be deferred by application of new § 1092. Of course, an adjustment must be made to the replacement leg analogous to the basis adjustment made under § 1091(d). Thus, in most cases, the disallowance of losses under the § 1091 rule functions merely to defer the loss.

Id.

[220] *See* I.R.C. § 1092(b).

[221] *See id.* § 1233(b). Thus, a contract to sell stock at a future date and at a specified price is a short sale. A short futures contract (a contract to sell) is also a short sale.

[222] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 144, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 243. For tax purposes, the gain or loss on a short sale is not recognized until

Section 1233(b) contains two rules designed to prevent conversion of short-term capital gain into long-term. The two rules under section 1233(b) apply when the gain or loss on a short sale will produce capital gain or loss and the taxpayer either (a) holds property on the date of the short sale which is "substantially identical" to the property used to close the short sale and which has *not* been held for the long-term holding period as of the date of the short sale, or (b) acquires "substantially identical property" after the short sale and before the closing.[223] Under the first rule, any gain upon the closing of the short sale is considered short-term gain, notwithstanding the holding period of the property used to close the short sale.[224] This prevents the locking-in of long-term capital gain discussed above.[225] Under the second rule, the holding period of substantially identical property not used to close the short sale is considered to begin on the date of the closing of the short sale (or on the date of the sale, gift, or other disposition of such property, whichever occurs first).[226] This rule addresses a variation on the basic lock-in technique where a taxpayer who holds substantially identical property acquires other substantially identical property in the market after the date of the short sale in order to close the short sale, and then sells the first mentioned "substantially identical" property. Conversion from short-term to long-term capital gain is prevented by treating the property that is sold as if it had been acquired on the date of the closing of the short sale.[227]

Section 1233(d) contains a third rule designed to prevent the conversion of long-term capital loss into short-term capital loss. This rule applies whenever the taxpayer holds property on the date of the short sale which has been held for longer than the long-term holding period and which is substantially identical to the property used to close the short sale.[228] Any loss realized upon the closing of such a short sale is treated as long-term loss, notwith-

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the short sale is closed upon delivery of the property. *See* Treas. Reg. § 1.1233-1(a)(1).

[223] *See* I.R.C. § 1233(b).

[224] *See id.* § 1233(b)(1); *see also* Treas. Reg. § 1.1233-1(c)(2).

[225] *See, e.g.*, Treas. Reg. § 1.1233-1(c)(6), Ex. (1).

[226] *See* I.R.C. § 1233(b)(2). This choice only applies to the extent such "substantially identical property" (accounted for in the order of acquisition) does not exceed the quantity sold short. *See id. See also* Treas. Reg. § 1.1233-1(c)(2).

[227] *See, e.g.*, Treas. Reg. § 1.1233-1(c)(6), Ex. (2).

[228] *See* I.R.C. § 1233(d).

standing the fact that the property used to close the short sale has been held for less than the long-term holding period.[229]

Before the enactment of section 1092(b), these three rules applied only to stocks and securities and to "commodity futures" that were capital assets in the taxpayer's hands.[230] They did not, however, apply to commodity futures requiring delivery in different calendar months because such property was not considered to be "substantially identical" property.[231] Consequently, prior to the enactment of the straddle provisions it was possible to convert short-term capital gains into long-term capital gains through the use of commodity straddles. This could occur where the long leg of the commodity straddle increased in value and was held for the six month long-term holding period,[232] as was the case in Revenue Ruling 77-185.[233] With the application of short sale principles to non-RFC and mixed straddles, the gain realized on the long leg will always be short-term capital gain.[234] As is true for the previ-

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[229] *See id. See, e.g.*, Treas. Reg. 1.1233-1(c)(6), Ex. (5).

[230] *See* I.R.C. § 1233(e)(2)(A). The short sale rule of § 1233 does not apply to physical commodities. *See id. See also* text accompanying notes 260-62 *infra*.

[231] *See id.* § 1233(e)(2)(B). The regulations give the following guidance for determining whether two commodity futures are substantially identical.

> [C]ommodity futures in May wheat and July wheat are not considered, for the purpose of § 1233, substantially identical property. Similarly, futures in different commodities which are not generally through custom of the trade used as hedges for each other (such as corn and wheat, for example) are not considered substantially identical property. If commodity futures are otherwise substantially identical property, the mere fact that they were procured through different brokers will not remove them from the scope of the term 'substantially identical property.' Commodity futures procured on different markets may come within the term 'substantially identical property' depending upon the facts and circumstances in the case, with the historical similarity in the price movements in the two markets as the primary factor to be considered.

Treas. Reg. § 1.1233-1(d)(2). Note that under § 1233(g), hedging transactions are also exempted from the short sale rule of § 1233. *See* I.R.C. § 1233(g).

[232] The longer term holding period for RFCs has not been lengthened to one year, as is the case with other capital assets. *See* I.R.C. § 1222.

[233] *See* notes 10-22 *supra* and accompanying text. If, however, the short leg increased in value, the taxpayer would always have had short-term capital gain, because it is not possible under the first and second rules of § 1233(b) to close out the transaction with a "substantially identical" long leg that has been held for more than six months. *See* I.R.C. § 1233(b).

[234] *See* I.R.C. § 1233(b). The new short sale rule does not apply to straddles comprised solely of RFC positions because they are governed exclusively by § 1256. *See id.* § 1256. If a taxpayer holds a mixed straddle and does not elect, pursuant to § 1256(d), to have § 1256 not apply, it is unclear whether gain on the RFC leg qualifies for 60-40 treatment, or in the alternative, is all short-term capital gain by reason of the short sale rule of § 1092(b). The

ously discussed wash sale rule, the "offsetting position" concept is to replace the "substantially identical" concept in applying the short sale rule under section 1092(b).[235]

F. Special Exemption for Straddles in Stock Options

Section 1092(d)(2)(B) provides a special rule for stock options by expanding the definition of a position to include stock options which are part of a straddle and are options to buy or sell stock that is actively traded.[236] The rule prevents the loss limitation rules of section 1092 from applying to any stock option which:

> (i) is traded on a domestic exchange or on a similar foreign exchange designated by the Secretary, and
> (ii) is of a type with respect to which the maximum period during which such option may be exercised is less than the minimum period for which a capital asset must be held for gain to be treated as long-term capital gain under section 1222(3).[237]

Thus, section 1092 does not apply to offsetting positions in exchange-traded stock options which have a maximum holding period of less than twelve months.[238] Since all domestic exchange-traded stock options have a maximum term of nine months, straddles in such options are presently exempt from section 1092. However, if either the maximum term of such options is increased to more than twelve months or the long-term capital asset holding period is reduced to less than nine months, then, depending upon the interpretation of the ambiguous "of a type" clause,[239] straddles in certain such options could become subject to section 1092.

The principal reasons for this limited exclusion for exchange-traded stock options are that it is not possible to convert short-term gain into long-term gain with such options[240] and that, al-

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Treasury will have to address this issue in regulations.

[235] *See* text accompanying note 214 *supra.*

[236] *See* I.R.C. § 1092(d)(2)(B).

[237] *Id.* § 1092(d)(2)(B)(i)-(ii).

[238] Twelve months is the currently required holding period for long-term capital gains. *See id.* § 1222(3).

[239] *Id.* § 1092(d)(2)(B)(ii).

[240] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 151, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 250. If stock options could be held for the long-term holding period and the straddle provisions did not apply, conversion might be accomplished if, for example, a taxpayer purchased a call option (i.e., took a long position in an option to buy) at a time when

though a taxpayer may use such options to defer taxation of short-term capital gain (subject, of course, to attack by the Service under the rationale of the *Smith* case[241]), there does not appear to have been any significant tax abuse with such options. It should be noted that stock is not subject to section 1092 because it is not "personal property" under section 1092(d)(1).[242]

If the holding period for long-term capital gains were to be shortened, the stock option exemption of section 1092(d)(2)(B) would almost certainly have to be amended to clarify its meaning. Indeed, when proposals were made during 1982 for reducing the holding period to six months,[243] technical conforming amendments to section 1092(d)(2)(B) were included.[244] The basic intent of the

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the option had more than the long-term holding period to run and entered into an offsetting position by writing a call (i.e., a short position) for a similar option but with a different expiration date or exercise price. If, as a result of price movements, there was a gain in the long position and a loss in the short position, the short position could be closed out before year end at a short-term capital loss, *see* I.R.C. § 1234(b), and the taxpayer could immediately enter into a similar call, thus staying in a straddle position. Assuming that prices held, in the following year, the long position could be closed out at a long-term capital gain, *see id.* § 1234(a), and the short position could be closed out without any substantial gain or loss.

[241] *See* notes 27-31 *supra* and accompanying text.

[242] *See* I.R.C. § 1092(d)(1).

[243] The Senate-passed version of the Tax Equity and Fiscal Responsibility Act of 1982 provided for a reduction of the long-term capital gains holding period to six months. *See* H.R. 4961, § 310, 97th Cong., 2d Sess. (Aug. 19, 1982) (as amended by the Senate); S. Rep. No. 494, 97th Cong., 2d Sess. 117, *reprinted in* 1982 U.S. Code Cong. & Ad. News 781, 883. When the Senate provision was rejected in conference, *see* H. Conf. Rep. 760, 97th Cong., 2d Sess. 409, 477, *reprinted in* 1982 U.S. Code Cong. & Ad. News 1190, 1256, Senator Robert Dole and Senator Harry F. Byrd, Jr. responded by offering an amendment to the then pending Debt Ceiling Legislation which would have likewise reduced the long-term holding period to six months. *See* Proposed Amendment No. 2030 to H.J. Res. 520, 97th Cong., 2d Sess., 128 Cong. Rec. S10705-10706 (daily ed. Aug. 17, 1982). Senator Dole later substituted an amendment for the proposed Dole-Byrd amendment which additionally would amend I.R.C. § 1092(d)(2)(B). *See* Proposed Unprinted Amendment No. 1249 to H.J. Res. 520, 97th Cong., 2d Sess., 128 Cong. Rec. S10710-10711 (daily ed. Aug. 17, 1982). This amendment was not enacted, nor was a similar amendment later adopted by the Senate Finance Committee. *See* H.R. 1524, §3, 97th Cong., 2d Sess. (1982) (as amended by the Senate Finance Committee); S. Rep. No. 643, 97th Cong., 2d Sess. 15 (1982); 128 Cong. Rec. S13233 (daily ed. Oct. 1, 1982). Several last minute attempts to revive the proposal were made during the lame-duck session, *see, e.g.*, 128 Cong. Rec. S14881 (daily ed. Dec. 15, 1982), but each time it was dropped from the bills to which it was attached. Senator Dole has a current bill, introduced January 26, 1983, which would reduce the holding period to six months. *See* S. 13, 98th Cong., 1st Sess. (Jan. 26, 1983).

[244] *See* H.R. 4961, § 310, 97th Cong., 2d Sess. (Aug. 19, 1982) (as amended by the Senate); Proposed Unprinted Amendment No. 1249 to H.J. Res. 520, 97th Cong., 2d Sess., 128 Cong. Rec. S10710-10711 (daily ed. Aug. 17, 1982); H.R. 1524, §3(d), 97th Cong., 2d Sess. (1982)

proposed amendments was to continue to exempt from the straddle provisions stock options that neither can be used for the purpose of converting short-term capital gain into long-term capital gain nor are held by a broker-dealer syndicate in its trading account.[245]

One proposal for reducing the long-term capital gains holding period was offered by Senator Dole as an amendment to the then pending Debt Ceiling Legislation (the so-called Dole amendment).[246] As part of this amendment, the revision of the stock option exemption would have excluded exchange-traded stock options which were:

> part of a straddle consisting of offsetting positions none of which would (without regard to the short-sale rules of subsection (b) of [section 1092]) result in the recognition of long-term capital gain or loss (or ordinary income or loss, if held by a syndicate, as defined in section 1256(e)(3)(B)) if sold by the taxpayer on the last day on which such option could be exercised.[247]

Under this amendment, positions in stock options that would otherwise be treated as offsetting positions under section 1092(c) and

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(as amended by the Senate Finance Committee); S. Rep. No. 643, 97th Cong., 2d Sess. 15 (1982); 128 Cong. Rec. S13233 (daily ed. Oct. 1, 1982).

[245] The non-conversion portion of the proposed amendments was urged by both the American Stock Exchange, Inc. (AMEX) and the Chicago Board Options Exchange, Inc. (CBOE) which together account for a substantial portion of the trading in exchange-traded stock options. The Exchanges pointed out that although most options have nine months to run at the time of introduction, many options when introduced have less than six months to run, and in any event, a taxpayer could hold offsetting positions in stock options when neither position has more than six months to run. The Exchanges argued that the original wording of the stock option exemption was ambiguous and with the adoption of a six-month holding period, the exemption could be interpreted so as (1) not to apply to certain offsetting positions in stock options that could be used for conversion (i.e., the offsetting positions consist of an option that could produce long-term capital gain and another that could not), and (2) to apply to certain other positions that could not be used for conversion (i.e., the offsetting positions consist of options that have more than six months to run at the time of acquisition). For a full statement of the position of the Exchanges, see Memorandum from Joseph F. McDonald on behalf of AMEX and Samuel C. Thompson, Jr. on behalf of CBOE sent to Assistant Secretary John Chapoton (July 20, 1982), *reprinted as* Tax Notes Document No. 82-8051. Senator Dole's current bill proposing reduction of the holding period also contains anti-conversion and syndicate rules. *See* S. 13, 98th Cong., 1st Sess. (Jan. 26, 1983). It should be noted that the special rule dealing with syndicates was added at the suggestion of the Treasury.

[246] *See* Proposed Unprinted Amendment No. 1249 to H.J. Res. 520, 97th Cong., 2d Sess., 128 Cong. Rec. S10710-10711 (daily ed. Aug. 17, 1982).

[247] *Id.*

that were held by a non-"syndicate" taxpayer would be exempt from section 1092 if all of the positions could result only in either short-term capital gain or loss or ordinary income or loss. Any such options held by a "syndicate" would be exempt only if such options could produce only short-term capital gain or loss. As a practical matter, the effect would be to prevent application of the straddle rules to investors (i.e., non-dealers) who traded exclusively in stock options that could produce only short-term capital gain or loss.[248] Under the amendment, the straddle rules would apply, however, to any investor-held straddle in stock options in which one position could give rise to long-term capital gain.[249]

Dealers in stock options (e.g., market makers) receive ordinary income or loss for stock options held in their trading account.[250] On the other hand, dealers receive capital gain or loss for stock options placed in their investment account.[251] Consequently, under the Dole amendment's proposed revision of section

[248] Under § 1234(b), an investor who writes an option to buy or sell has short-term capital gain or loss on closing transactions and short-term gain on lapse. Consequently, such an option can never produce long-term capital gain no matter how long the option is held. On the other hand, under § 1234(a), an investor who purchases an option to buy or sell will have long-term or short-term capital gain or loss depending upon the period the option is held. Therefore, under the proposed six month reduction in the long-term holding period, an investor could be sure that he is not within the straddle rules as long as he does not acquire an option that has more than six months to run.

[249] If a six month long-term holding period rule was in effect, such a position could consist of a call option that had been purchased at a time when it had more than six months to run.

[250] *See* I.R.C. § 1234(a)(3)(A)-(B), (b)(3). The Joint Committee's General Explanation of the Tax Reform Act of 1976 makes it clear that dealers in options receive ordinary income or loss for items in their trading accounts:

> [T]he rules . . . with respect to closing transactions and option lapse income are not to apply in the case of options written by the taxpayer in the ordinary course of his trade or business. Gain or loss from transactions in options written in the ordinary course of the taxpayer's trade or business would continue to be treated as ordinary income or loss . . . . Generally, it is anticipated that persons who are treated as writers of options in the ordinary course of their trade or business will be those who "make a market" with respect to a particular option."

General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. 675 (J. Comm. Print 1976)(prepared by the Staff of the Joint Committee on Taxation).

[251] *See* I.R.C. § 1236. Section 1236 requires a dealer in "securities" to segregate securities acquired for investment from those acquired in the ordinary course of trade or business. *See* notes 305-14 *infra* and accompanying text. The term "security" is defined in § 1236(c) to include options to purchase (i.e., calls), but on its face the statute does not include rights to sell (i.e., puts) or the writing of a call or put. *See* I.R.C. § 1236(c). However, § 1236(c) does include "any evidence of an interest in" a security. *See id.*

1092(d)(2)(B)(ii), a non-syndicate dealer would be exempt from the straddle rules for all stock options held in his trading account and, like the investor, would be exempt for all stock options held in his investment account that were not part of straddles in which one leg could produce long-term capital gain.

Syndicates are defined in section 1256(e)(3)(B) to mean any partnership, subchapter S corporation or other flowthrough entity for which more than thirty-five percent of the losses for the entity during the taxable year are allocated to limited partners or limited entrepreneurs (within the meaning of section 464(e)(2)).[252] The classic example of a syndicate is a publicly held limited partnership where most of the gains and losses are allocated to the limited partners. Such vehicles are organized for the purpose of becoming market maker/dealers on stock option exchanges. Since stock options are exempt from the straddle provisions, such syndicates could, subject to the *Smith* limitation,[253] generate ordinary losses by entering into straddle transactions in stock options that are held in their trading accounts and pass those losses through to the limited partners. As will be seen below in the discussion of the syndicate exception to the hedging rule,[254] syndicates that trade in debt options (as opposed to stock options) are not exempt from the straddle provisions.

Because of the perception by the Treasury that syndicates trading in stock options can be used for tax abuse, the proposed revision of section 1092(d)(2)(B)(ii) was written to make the straddle provisions apply both to the ordinary income positions held by a syndicate and to any position that is part of a straddle held by a syndicate, if any leg of that straddle could produce long-term capital gain.

The Dole amendment was subsequently dropped from the Debt Ceiling Legislation; however, the Senate Finance Committee later adopted a six month holding provision with a similar exemption for stock options.[255] The stock option exemption in section

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[252] *See* I.R.C. § 1256(e)(3)(B). For further discussion of the definition of a syndicate, see note 285 *infra*.

[253] *See* text accompanying notes 27-31 *supra*.

[254] *See* notes 285-87 *infra* and accompanying text .

[255] *See* H.R. 1524, § 3, 97th Cong., 2d Sess.(1982) (as amended by the Senate Finance Committee) (died in the Senate in late 1982). *See also* S. Rep. No. 643, 97th Cong., 2d Sess. 15 (1982); 128 Cong. Rec S13233 (daily ed. Oct. 1, 1982).

1092(d)(2)(B)(ii) was restructured to read as follows:

> (ii) is part of a straddle none of the offsetting positions of which would, if sold by the taxpayer on the last day on which such option could be exercised, result in the recognition of
> (I) long-term capital gain or loss, or
> (II) in the case of a syndicate (within the meaning of section 1256(e)(3)(B)), long-term capital gain or loss or ordinary income or loss.[256]

Thus, under the later Senate Finance Committee proposal, the stock option exemption remained substantively the same except for an addition made at the Treasury's insistence to limit the ordinary income exemption for dealers according to the following rule:

> For purposes of subparagraph (B)(ii):
> (i) A stock option (other than an option meeting the requirements of section 1236) held by a dealer shall not be treated as meeting the requirements of such subparagraph unless such option is entered into in the normal course of the dealer's trade or business, and
> (ii) the determination as to whether a sale would result in long-term capital gain or loss shall be made without regard to the rules of subsections (b) and (d) of § 1233 (as made applicable by reason of subsection (b)).[257]

This requirement is the same as the normal course requirement that applies to the hedging exemption.[258] The apparent purpose of this additional normal course requirement was to clarify that if a dealer entered into straddles in stock options held in his trading account and such options were not entered into in the normal course of the dealer's trade or business of market making, but rather were entered into for tax avoidance purposes (e.g., for the purpose of deferring ordinary income), then even though the options might give rise to ordinary income or loss, such options would still be subject to section 1092. The underlying assumption of the amendment was that a dealer could have ordinary income treat-

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[256] H.R. 1524, § 3(d)(1), 97th Cong., 2d Sess. (1982) (as amended by the Senate Finance Committee).

[257] *See id.* at § 3(d)(2). The new rule was added as new subsection 1092(d)(2)(C).

[258] The committee report made it clear that the new § 1092(d)(2)(C)(i) was not intended to apply to options held in a dealer's investment account. *See* S. Rep. No. 643, *supra* note 243, at 16.

ment for transactions not entered into in the normal course of his business.[259] If the long-term capital gains holding period is shortened, the revision of the stock option exemption to account for that reduction will probably be similar to the final version of the above suggested amendments.

IV. Miscellaneous Straddle Provisions

A. *Cash and Carry Transactions*

As noted in the discussion of the short sale rule, section 1233 applies to commodity futures but does not apply to physical commodities.[260] As a consequence, it was possible under prior law to obtain long-term capital gain on the transfer of a physical commodity in closing out a short sale while obtaining ordinary deductions for the cost of carrying the commodity from the date of its acquisition to the date of its sale, thereby both deferring income and converting ordinary income into long-term capital gain in an essentially riskless transaction.

For example, an investor could finance the purchase of a physical commodity, such as silver, for a total purchase price of $10,000 and immediately enter into a short futures contract for the sale of the same quantity of silver for a total sales price of $11,000, with delivery due twelve months later. The investor's position for the year is essentially riskless. The $1,000 difference between the purchase price of the physical silver and the sales price of the futures contract is principally a function of the cost of carrying silver for one year (i.e., the storage, insurance, and interest charges).[261] These costs are deductible either as interest under section 163 or as expenses for the production of income under section 212. Consequently, the investor will have a $1,000 deduction against unrelated ordinary income. Since the short sale rule does not apply here, the physical silver, which is a capital asset in the investor's hands, can be "carried" for the twelve month long holding period, giving the investor a $1,000 long term capital gain when he delivers

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[259] Although this assumption may be questionable, a similar assumption is implicit in the structure of the hedging exemption. *See* text accompanying notes 273-75 *infra*.

[260] *See* I.R.C. § 1233(e)(2)(A). *See also* note 230 *supra* and accompanying text.

[261] *See* House Hearing, *supra* note 2, at 68 (statement by John Chapoton, Asst. Sec'y of Treasury for Tax Policy).

the silver in closing out the short futures contract.[262]

In order to curtail the perceived abuse with respect to cash and carry transactions, ERTA added new section 263(g) to the Code.[263] This new provision disallows deductions for "interest and carrying charges properly allocable to personal property which is part of a straddle."[264] The disallowed deductions are capitalized,[265] and the increase in basis acts to lower any capital gain realized on the sale of the property rather than to offset ordinary income.

The capitalization requirement as currently defined applies to interest on indebtedness incurred to purchase the straddle property and all other costs (including charges for the temporary use of borrowed property) incurred in insuring, storing, transporting or carrying the property.[266] The amount of the charges to be capitalized is reduced by any interest income and income acquisition discount from the property which is includible in the taxpayer's gross income for the year.[267]

This capitalization requirement does not apply to hedging transactions;[268] therefore, a farmer still can deduct currently the costs of financing crops.[269] Similarly, the expenses of securities dealers for financing their inventory and trading accounts which generate ordinary income or loss are still deductible.[270]

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[262] *See* Selig and Schmittberger, *Tax Aspects of Commodity Futures Trading*, *supra* note 9, at 97-98 (1977).

[263] *See* Pub. L. No. 97-34, § 502, 95 Stat. 172, 327 (1981); I.R.C. § 263(g).

[264] I.R.C. § 263(g)(1). Since the provision applies to property that is "part of a straddle," the offsetting position rules of § 1092 apply. *See id.* § 1092(c).

[265] *See id.* § 263(g)(1).

[266] *See id.* § 263(g)(2)(A). The Technical Corrections Act amended § 263(g)(2)(A)(ii) to clarify that "charges for the temporary use of personal property borrowed in connection with a short sale must be capitalized to the same extent that interest must be capitalized." *See* S. Rep. No. 592, 97th Cong., 2d Sess. 28 (1982). The text of amended § 263(g)(2)(A)(ii) now reads:

> (ii) all other amounts (including charges for temporary use of the personal property in a short sale, or to insure, store, or transport the personal property) paid or incurred to carry the personal property . . .

Pub. L. No. 97-448, § 105(b)(1), 96 Stat. 2365, 2385 (1983). The above amendment applies to property acquired, and positions established, after September 22, 1982, in taxable years ending after such date. *See id.* § 105(b)(2), 96 Stat. 2365, 2385 (1983).

[267] *See* I.R.C. § 263(g)(2)(B); S. Rep. No. 144, 97th Cong., 1st Sess. 154, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 253.

[268] *See* I.R.C. § 263(g)(3).

[269] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 154, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 253.

[270] *See id.*

B. The Hedging Exemption

The mark to market rule for RFCs, the capitalization of carrying costs rule for cash and carry transactions, and the disallowance of loss rule for non-RFC straddles do not apply to hedging transactions.[271] There are three principal requirements that must be met for the hedging exemption to apply.[272] First, the hedging transaction must be entered into in the normal course of the taxpayer's business, primarily in order to reduce the risk of price fluctuations.[273] Second, the gain or loss on the transaction must be ordinary.[274] For example, speculation in commodity futures contracts does not qualify for the hedging exemption because futures speculation always produces only capital gains or capital losses.[275] Therefore, even a professional futures trader who engages in speculation in the ordinary course of his business will not come under the hedging exemption. Third, the taxpayer must clearly identify the transaction as a hedging transaction before the close of the day on which the taxpayer entered into the transaction.[276] The concept of hedging is amplified in the Senate Finance Report:

> Hedging transactions are varied and complex. They may be executed in a wide range of property and forms, including options, futures, forwards, and other contract rights and short sales. A hedging transaction may be executed to reduce the risk of price change or of currency fluctuations with respect to property which

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[271] *See* I.R.C. §§ 1256(e)(1) (mark to market rule), 263(g)(3) (cash and carry transactions rules), 1092(e) (disallowance of loss rule).

[272] *See* I.R.C. § 1256(e)(2).

[273] *See* I.R.C. § 1256(e)(2)(A). Section 1256(e)(4) provides that banks need not fulfill the requirement of § 1256(e)(2)(A) that the transaction be "primarily (i) to reduce risk of price change . . . with respect to property which is held or to be held . . . or (ii) to reduce risk of interest rate or price changes . . . with respect to borrowings." *Id.* § 1256(e)(4). Thus, banks need not be concerned with the "primarily" concept. This exemption in § 1256(e)(4) was added on the Senate floor at the suggestion of Senator Moynihan, *see* 127 Cong. Rec. S8643 (daily ed. July 28, 1981), but no reason was given for the amendment. The Joint Committee Report on ERTA offers this explanation:

> This special rule is intended to allow certain business activities which are conducted regularly by banks, but which may not be conducted primarily for risk reduction (for example, foreign currency trading), to qualify for the hedging exemption.

General Explanation, *supra* note 58, at 299.

[274] *See* I.R.C. § 1256(e)(2)(B).

[275] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 159, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 258.

[276] *See* I.R.C. § 1256(e)(2)(C).

> is held or to be held by the taxpayer . . . . [A] hedging transaction may be executed to reduce risk of price or interest rate changes, or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer . . . .[277]

When enacting the hedging exemption, Congress apparently intended for Treasury to promulgate regulations to provide for blanket identification of certain classes of transactions as hedging transactions without a requirement of matching up the hedged property with the hedging property.[278] The purpose of this blanket identification is to minimize bookkeeping requirements in as many cases as practicable.[279] One suggestion made by the Senate Finance Committee Report is that taxpayers, such as banks and securities dealers, who engage in a tremendous volume of complex hedging transactions be allowed to mark entire accounts as hedging accounts so long as these accounts only involve ordinary income items.[280] This blanket identification rule has merit in such cases both because of the difficulty of making independent identifications and because the opportunities for manipulating hedging transactions to obtain deferral or conversion are minimal.[281]

Two special rules concerning hedging transactions are contained in section 1256(f). Under section 1256(f)(1), if property is at any time identified by the taxpayer as being part of a hedging transaction, gain from that property will never be considered to be capital gain even if the transaction is ultimately determined not to be a hedging transaction within the meaning of section 1256(e).[282] Any

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[277] S. Rep. No. 144, 97th Cong., 1st Sess. 159, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 258.

[278] *See id.*

[279] *See id.*

[280] *See id.* at 151, 159, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 251, 258.

[281] *See id.* at 159-60, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 258-59. The Report explains:

> If [a] bank's securities trading account, which produces only ordinary income or loss, is managed and recorded independently and separately from the bank's investment account (and any other capital asset account), there is little danger of manipulation for conversion. Moreover, because Federal regulatory agencies impose certain standard accounting practices on banks, their deferral opportunities too are limited. Thus, detailed identification or matching of such hedging activities ordinarily would serve no useful purpose.

Id.

[282] *See* I.R.C. § 1256(f)(1). This rule only applies to property that is "personal property" as defined in § 1092(d)(1). *See id.*

loss, however, with respect to such property would be either capital loss or ordinary depending upon the character of the property under general principles of taxation. For example, if an RFC was identified as being part of a hedging transaction that was later found not to qualify as such, then the mark to market rule would apply. Any gain would be treated as ordinary income, but the loss would be treated as sixty percent long-term capital loss and forty percent short-term, unless it was found to be ordinary loss under the rationale of the *Corn Products* case.[283] Section 1256(f)(2) provides that the thirty-two percent maximum effective tax rate for RFCs does not apply where the RFC is an ordinary income or loss item, as, for example, when it is part of a hedging transaction.[284]

Under section 1256(e)(3)(A), a "syndicate"[285] cannot qualify for the hedging exemption.[286] The purpose of this provision is to prevent possible manipulation of the hedging exemption by tax shelters structured as limited partnerships.[287]

As a final point on the hedging exemption, it should be noted that the Senate Finance Committee took care to state that the hedging exemption is "in no event . . . to be interpreted as precluding the [Service] from exercising [its] present law authority to

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[283] *See* Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955) (purchases and sales of corn futures were an integral part of taxpayer's manufacturing business and gave rise to ordinary income and deductions.)

[284] *See* I.R.C. § 1256(f)(2).

[285] *See id.* § 1256(e)(3)(B). In determining whether an entity is a syndicate, an interest held by (1) an active participant in management, (2) a family relative of an active participant, (3) a formerly active participant, (4) the estate of a active participant, or (5) a person the Secretary determines (by regulation or otherwise) should be treated as an active participant, shall not be treated as held by a limited investor. *See* I.R.C. § 1256(e)(3)(C)(i)-(v). Section 1256(e)(3)(C)(v) was amended by the Technical Corrections Act expressly to authorize the Treasury to prescribe regulations to determine that certain interests are not to be treated as held by limited partners or limited entrepreneurs for purposes of the syndicate rule. *See* Pub. L. No. 97-448, § 105(c)(3), 96 Stat. 2365, 2385 (1983). Thus, as amended the new section states:

> (v) if the Secretary determines (by regulation or otherwise) that such interest should be treated as held by an individual who actively participates in the management of such entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes.

I.R.C. § 1256(e)(3)(C)(v).

[286] *See id.* § 1256(e)(3)(A).

[287] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 160, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 259. Thus, a commodity pool or a partnership organized to be a dealer in debt securities could not take advantage of the hedging exemption if more than 35% of the partners were limited partners. *See id.*

require that taxpayers employ accounting methods which clearly reflect their income."[288]

C. Government Obligations Issued at a Discount

Under prior law, government obligations issued at a discount and payable without interest at a fixed maturity of less than one year were treated as ordinary income assets.[289] Treasury bills, for example, were treated as ordinary income assets. However, the Service had ruled that futures contracts to purchase Treasury bills were capital assets.[290] As a result, taxpayers were able to structure straddles in Treasury bills that could produce a current ordinary loss upon delivery of the physical Treasury bills in closing out a short contract and a capital gain upon the offsetting of the profitable long contract.[291]

ERTA amended section 1221 of the Code to make Treasury bills and other such discount obligations capital assets.[292] Any discount

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[288] *Id.*

[289] *See* I.R.C. § 1221(5) (prior to amendment by Pub. L. No. 97-34 (1981)).

[290] *See* Rev. Rul. 78-414, 1978-2 C.B. 213.

[291] The Senate Finance Committee Report discusses this tax deferral and conversion device:

> Tax straddles in Treasury bill futures are believed to offer features unavailable in other futures straddles. These shelters can be used to convert ordinary income, including, for example, salary, wages, interest, and dividends, into long-term capital gain. This opportunity occurs because, under statutory rule, gain or loss on the sale of Treasury bills is considered ordinary income or loss, while, under IRS interpretation, gain or loss on the sale of T-bill futures contracts is considered capital gain or loss. Straddles in Treasury bill futures generally are structured in the same way as other futures straddles: contracts to buy Treasury bills are offset by an equivalent number of contracts to sell Treasury bills. The execution of these "T-bill" shelters involves one difference: in the case of a loss on a long leg, when the delivery month for the loss leg of the straddle arrives, the taxpayer takes delivery of the bills and then disposes of the bills themselves creating an ordinary loss: in the case of a loss on a short leg, the taxpayer purchases the bills at the market price and delivers the bills themselves at the contract's lower price creating an ordinary loss. Ordinary losses are fully deductible against any type of ordinary income.
>
> The remainder of the straddle transaction is executed in the usual fashion. The taxpayer immediately replaces the liquidated leg. In the following year, the entire straddle is closed out and, if the gain occurs on the long position (contract to buy), the gain is reported as long-term capital gain. Some taxpayers may decide to re-straddle in the second year and roll-over their gains and other income indefinitely into the future.

S. Rep. No. 144, 97th Cong., 1st Sess. 165-66, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 263.

[292] *See* Pub. L. No. 97-34, § 505(a), 95 Stat. 172, 331 (1981). ERTA repealed § 1221(5)

at issue is to be considered interest and taxed under generally applicable tax rules.[293] The original issue discount provision, section 1232, is also amended[294] by adding section 1232(a)(4) which provides that, upon disposition of an obligation issued at a discount, the taxpayer's gain is treated as ordinary income to the extent of his ratable share of "acquisition discount."[295] The taxpayer's ratable share is determined by the number of days the taxpayer has held the obligation.[296] Any gain exceeding the taxpayer's ratable share of acquisition discount is short-term capital gain[297] and any loss is short-term capital loss.[298]

D. *Terminations*

Under prior law, the disposition of a capital asset by lapse, cancellation or abandonment was considered not to be a sale or exchange.[299] As a result, taxpayers could enter straddle transactions in forward contracts and cancel the loss leg, claiming ordinary loss, and sell the gain leg, claiming capital gain.[300]

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and redesignated § 1221(6) as § 1221(5). *See id.*

[293] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 166, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 264; *see, e.g.*, United States v. Midland Ross Corp., 381 U.S. 54 (1965).

[294] *See* Pub. L. No. 97-34, § 505(b), 95 Stat. 172, 331-32 (1981).

[295] *See* I.R.C. § 1232(a)(3)(A). The Tax Equity and Fiscal Responsibility Act of 1982 repealed § 1232(a)(3) and redesignated § 1232(a)(4) as § 1232(a)(3). *See* Pub. L. No. 97-248, § 231(c)(4), 96 Stat. 325, 499 (1982). Thus the amendment by ERTA is now reflected in § 1232(a)(3). *See also* S. Rep. No. 144, 97th Cong., 1st Sess. 166-67, *reprinted* in 1981 U.S. Code Cong. & Ad. News 105, 264.

[296] *See* I.R.C. § 1232(a)(3)(D).

[297] *See id.* § 1232(a)(3)(A).

[298] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 167, *reprinted* in 1981 U.S. Code Cong. & Ad. News 105, 264.

[299] I.R.C. § 1222 defines capital gains or loss as gain or loss from the sale or exchange of a capital asset. *See* I.R.C. § 1222. Court decisions prior to ERTA interpreted the "sale or exchange" requirement to mean that dispositions of assets that were not strictly sales or exchanges produced ordinary income or loss. *See* Teh v. Commissioner, 260 F.2d 489 (9th Cir. 1952); Commissioner v. Pittson Co., 252 F.2d 344 (2d Cir. 1958), *cert. denied* 357 U.S. 919 (1958); *see also* S. Rep. No. 144, 97th Cong., 1st Sess. 170, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 266-67.

[300] The Senate Finance Committee Report gives the following example of this type of transaction:

> [A] taxpayer may simultaneously enter into a contract to buy German marks for future delivery and contract to sell German marks for future delivery with very little risk. If the price of German marks thereafter declines, the taxpayer will assign his contract to sell marks to a bank or other institution for a gain equivalent to the excess of the contract price over the lower market price and cancel his obligation to buy

ERTA rectified this tax avoidance device by adding section 1234A to the Code.[301] Amended by the Technical Corrections Act,[302] this section provides that:

> [g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of—
>
> (1) a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
>
> (2) a regulated futures contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset.[303]

Property subject to this rule is any personal property (other than stock) of a type which is actively traded or any RFC.[304]

E. *Prompt Identification of Securities by Dealers*

Under section 1236, a securities dealer receives capital gain on the sale of securities if he satisfies two conditions. First, the dealer must clearly identify the security as being held for investment,[305] and second, after such identification, the dealer must never hold the security primarily for sale to customers.[306] If a dealer does not satisfy the above two conditions, gain on the sale of securities will be ordinary gain.[307] Any loss realized with regard to a security which is initially identified as held for investment is in all cases a capital loss, regardless of whether the security is later held for sale to customers.[308] Thus, if a security is identified as being held for investment but later is held for sale to customers, any gain on its sale is ordinary income and any loss is capital loss. Any security

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> marks by payment of an amount in settlement of his obligation to the other party to the contract. The taxpayer will treat the sale proceeds as capital gain and will treat the amount paid to terminate his obligation to buy as an ordinary loss.

S. Rep. No. 144, 97th Cong., 1st Sess. 171, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 267.

[301] *See* Pub. L. No. 97-34, § 507, 95 Stat. 172, 333 (1981).

[302] *See* Pub. L. No. 97-448, § 105(e), 96 Stat. 2365 (1983).

[303] I.R.C. § 1234A.

[304] *See id.*

[305] *See id.* § 1236(a)(1).

[306] *See id.* § 1236(a)(2).

[307] *See id.* § 1236(a).

[308] *See id.* § 1236(b).

not held in the dealer's investment account produces ordinary income or loss.

Under prior law, the dealer had thirty days to identify his investment securities;[309] therefore, the dealer could wait to see whether a particular security would appreciate in value. If the security appreciated, the dealer could transfer it to his investment account, so as to later receive long-term capital gain. If the security lost value, the dealer could hold it in his trading account with the possibility of ordinary loss upon its sale. The Senate Finance Report elaborated on this tax avoidance opportunity:

> Some taxpayers consider securities dealers' unique tax-planning opportunities so significant that they establish themselves as broker-dealers solely to exploit these opportunities. Large broker-dealer partnerships pass these tax benefits through to hundreds of partners. Many of these broker-dealer partnerships sell shares in their operations for fees which are based on a percentage, usually ten percent of the tax loss sought by the investor.[310]

In order to address this problem, ERTA amended section 1236 to require that any security that is to be held for investment must be so identified on the day of acquisition.[311] A specialist in stocks traded on an exchange is given seven business days after acquisition to make the identification.[312]

The Senate Finance Report takes the position that in order for a security that is part of an offsetting position to be treated as identified as an investment security, all securities making up the offsetting position must be so identified.[313] This requirement could be difficult to comply with since offsetting positions are not necessarily acquired at the same time. Also, this requirement may lead an auditing agent to compare all of a dealer's investment positions held at year end with respect to which there is unrealized gain with all of the closed loss positions in his trading account to determine whether any of the positions were offsetting. Obviously, this could create serious administrative difficulties.

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[309] *See id.* § 1236(a)(1) (prior to amendment by Pub. L. No. 97-34 (1981)).

[310] S. Rep. No. 144, 97th Cong., 1st Sess. 168, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 265.

[311] *See* Pub. L. No. 97-34, § 506(a), 95 Stat. 172, 332 (1981); I.R.C. § 1236(a)(1).

[312] *See* Pub. L. No. 97-34, § 506(b), 95 Stat. 172, 332-33 (1981); I.R.C. § 1236(d)(1).

[313] *See* S. Rep. No. 144, 97th Cong., 1st Sess. 169, *reprinted in* 1981 U.S. Code Cong. & Ad. News 105, 266.

The Technical Corrections Act added new section 1236(e) which permits a dealer in securities who acquires a security in connection with the exercise of an option to treat the security as an investment item only if the dealer identifies the option as an investment on the day of its acquisition.[314]

V. Conclusion: Some Reflections on the Straddles Provisions

It would appear that the straddle provisions have accomplished the Congressional purpose for which they were enacted. Certainly, the provisions eliminate the possibility of using straddles for deferral and conversion of income in situations such as those in the examples given in the Joint Committee report quoted at the beginning of this article.

Those sections of the straddle provisions which (1) change the treatment of Treasury bills from ordinary income assets to capital assets, (2) treat terminations as sales or exchanges, and (3) eliminate the thirty day grace period for the identification of investment securities held by dealers, are very focused provisions which address particular problems that existed under prior law. Moreover, they do not add a great deal of complexity to the Code.

On the other hand, the mark to market rule of section 1256 and the disallowance of loss rule of section 1092 seem to go further than is necessary to correct the problems at which they are directed. In addition, these provisions add considerable complexity to the Code. Section 1092 in particular, which introduces the substantial diminution of risk concept and applies wash sale and short sale rules in the context of straddles, is potentially a bureaucratic nightmare. The cash and carry rule, although it accomplishes the

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[314] *See* Pub. L. No. 97-448, § 105(d)(1), 96 Stat. 2365, 2387 (1983); I.R.C. § 1236(e). The precise language of § 1236(e) is:

> (e) *Special Rule for Options.*—For purposes of subsection (a), any security acquired by a dealer pursuant to an option held by such dealer may be treated as held for investment only if the dealer, before the close of the day on which the option was acquired, clearly identified the option on his records as held for investment. For purposes of the preceding sentence, the term 'option' includes the right to subscribe to or purchase any security.

I.R.C. § 1236(e). Section 1236(e) applies to securities acquired after September 22, 1982, in taxable years ending after such date. *See* Pub. L. No. 97-448, § 105(d)(2), 96 Stat. 2365, 2387 (1983).

purpose for which it was enacted, becomes operative only in situations in which section 1092 applies, so it is built upon the substantial diminution of risk concept and all of this concept's attendant uncertainty.

Section 1092(a) appears to be overreaching in its application to straddle transactions in which the taxpayer does not replace the loss leg. For example, if a calendar year taxpayer is in a straddle position on January 1 of a tax year and disposes of the loss leg on January 2 but continues to hold the gain leg until the end of his tax year on December 31, the loss will be allowed only to the extent it exceeds the unrecognized gain in the gain leg on December 31, even though the taxpayer is not in a straddle for a full 363 days. This is clearly not a tax abuse situation, and there seems to be no good reason to defer the loss.

The appropriate application of section 1092(a) is to situations that present real tax avoidance possibility. The egregious example is the cash basis taxpayer in a straddle position at year end who disposes of both legs and takes a loss deduction for the year but defers the gain until the second year when the proceeds are received. The Technical Corrections Act recently clarified that section 1092 applies to this situation.[315] In order to have 1092(a) apply only to those situations that present the opportunity for abuse, consideration should be given to amending 1092(a) to make it apply only where the loss leg of a straddle is disposed of within thirty days of the end of the taxpayer's tax year. Of course, the wash sale rule would apply if the loss leg is replaced within the sixty-one day period.

Although the thirty-two percent rate for RFCs was viewed as the *quid pro quo* for the imposition of the mark to market rule, such a rate could result in market distortion by tilting investors toward RFCs and away from other forms of investments that perform similar economic functions, such as debt options, commodity options and forward contracts. Indeed, the successful efforts of bank forward users to have RFC treatment accorded bank forward contracts (as evidenced by the recent amendments of the Technical Corrections Act)[316] may presage similar efforts by other industries. Presumably, bank forward users decided that the mark to market

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[315] *See* notes 173-74 *supra* and accompanying text.

[316] *See* notes 81-91 *supra* and accompanying text.

treatment at year end was a small price to pay for the thirty-two percent rate.

As a policy matter, it seems that an investor who realizes a $1,000 gain on an RFC should receive the same type of treatment as an investor who has a $1,000 gain on an option or a forward contract. For this reason, consideration should be given to extending the mark to market rule and the thirty-two percent rate to all types of investment instruments that are economically similar to RFCs.

Despite the problems discussed above, Congress has essentially accomplished its purpose in enacting the anti-straddle provisions. These provisions should successfully prevent "people who make a lot of money" from using tax straddles to "pay no taxes."