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Do What I Say, Not What I Do: The US Internal Revenue Service Finalizes Changes to the Mixed Straddle Rules

By Mark Leeds [1]

A common parenting conundrum is presented by the larger sibling who continually uses force to get his or her way with their smaller counterpart. After seeing the larger child repeatedly strike the smaller sibling in order to get his or her way, a frustrated parent may be tempted to exclaim, "If you hit him again, I will spank you!" It's clear, however, that a caregiver cannot expect his ward to refrain from using force if the caregiver uses force to correct aberrant behavior.

The US Internal Revenue Service (the "IRS"), however, may have placed itself in exactly this position in promulgating changes to the mixed straddle regulations. In final regulations issued on July 17, 2014, the IRS has prevented taxpayers from recognizing losses on identified mixed straddle positions, but will force taxpayers to recognize gains on many of such transactions. In other words, the cure was not to simply prevent selective loss recognition, but instead to force only gain recognition.

Mixed Straddles: Tax Straddles Utilizing Financial Instruments Subject to 60/40 Mark-to-Market Accounting

The Internal Revenue Code of 1986, as amended (the "Code") has long provided rules for straddle positions in actively traded personal property.[2] Actively traded personal property includes foreign currency traded in the interbank market,[3] debt traded in a debt market[4] and stock traded on a national securities exchange or an interdealer quotation system.[5] These rules were enacted in response to taxpayer attempts to enter into offsetting positions and trigger the loss leg of straddle before the gain leg was recognized.[6] Accordingly, the major emphasis of the tax straddle rules is to prevent taxpayers from recognizing a loss on a leg of a straddle to the extent that the taxpayer has unrecognized gain on another straddle leg.[7]

A "mixed straddle" exists when four conditions are met: (i) all of the positions in the straddle are capital assets, that is, none of the positions in the straddle are inventory, (ii) at least one, but not all, of the positions, in the straddle are "Section 1256 contracts," (iii) the taxpayer has not made an election under Code § 1256(d) and (iv) the straddle is not part of a larger straddle.[8] Section 1256 contracts include regulated futures contracts, certain foreign currency contracts, nonequity options and dealer securities futures contracts.[9]

The tax accounting for Section 1256 contracts is unique. These contracts are taxed on a mark-to-market basis; 40% of the gain or loss from mark-to-market adjustments is treated as short-term capital gain or loss and the remaining 60% is treated as long-term capital gain or loss.[10] A taxpayer that has made an election under Code § 1256(d) elects to forego such treatment for Section 1256 contracts held as part of a mixed straddle.[11]

The IRS has not promulgated rules for when a straddle is part of a larger straddle. This challenge exists when a straddle leg offsets two or more offsetting positions. For example, assume that a taxpayer has a long position in publicly traded stock. In order to protect the appreciation in such stock, the taxpayer purchases a put option on the stock with a strike price equal to the then trading price of the stock. The taxpayer finds the cost of the put option to be expensive, so in order to reduce the out-of-pocket cost for the at-the-money put option, the taxpayer sells a non-traded call option, enabling the call option purchaser to acquire the stock at 115% of the then trading price of the stock. (These two option positions are referred to as a "collar.") In this case, the put option offsets both of the long stock position and the short call option position. Accordingly, even if the put option constituted a Section 1256 contracts, it is unlikely that the taxpayer would have a mixed straddle because the fourth requirement would be violated.

Furthermore, the mixed straddle regulations do not provide parameters for several important issues. First, no guidance is provided on any duration issues. A mixed straddle can exist even if the mixed straddle is in effect for a much shorter duration than the hedged position. For example, a mixed straddle can exist even if a taxpayer hedges a long 30-year bond position by shorting Treasury futures for one day. It is important to note, however, that if there is a loss in the long position, the short position in the Section 1256 contract would have to be in place for at least 30 days in order to avoid a wash sale.[12] The wash sale rule would limit a taxpayer's ability to claim a loss on the long position. Second, a straddle can exist even if the position represented by Section 1256 contract has a much different duration than the hedged bond. For example, a mixed straddle can exist if a taxpayer holding 30-year bonds hedges such bonds by shorting futures for two-year Treasury obligations. Last, it is not clear whether principal amounts of the two sides must be equal. In other words, is all of the gain or loss on a bond portfolio triggered when, in a mixed straddle account, a taxpayer holds $100 million of bonds, but only $10 million of short positions in Treasury futures?

The federal income tax consequences from holding a mixed straddle can be extremely adverse. As noted above, gains and losses on Section 1256 are accounted for on a mark-to-market basis, whereas the other leg of a mixed straddle, by definition, is not. Accordingly, if a taxpayer enters into a mixed straddle and, at year-end, the Section 1256 contract is in-the-money, the taxpayer would be required to recognize gain on the Section 1256 contract, but would not recognize the corresponding loss on the non-Section 1256 contract leg of the straddle. Applicable regulations also recharacterize the loss from the non-Section 1256 contract leg of a mixed straddle that has not been held for more than one year as a 60% long term capital loss.[13] This rule prevents taxpayers from using Section 1256 contracts to generate 60% long term capital gains when there is a position offsetting the Section 1256 contract that would generate only a short term capital loss.

The Mixed Straddle Election

Code § 1092(b)(2) authorizes the IRS to provide rules for mixed straddles. This direction of authority provides that the IRS can promulgate rules for mixed straddles on a straddle-by-straddle basis as well as for mixed straddle accounts. The IRS promulgated regulations for both types of mixed straddles.[14] In order for taxpayers to take advantage of these rules, they have to either identify the positions in the mixed straddle on a straddle-by-straddle basis or establish an account that is designated as a mixed straddle account. When a taxpayer identifies the legs of a mixed straddle, the positions are referred to as a "section 1092(b) identified mixed straddle."[15] When a taxpayer

establishes an account into which mixed straddles are placed (eliminating the need for straddle-by-straddle identification), the account is referred to as a "mixed straddle account."[16] In both cases, rules are provided that mitigate the negative consequences of a mixed straddle that are described above.

Pre-Straddle Gain or Loss

In order to isolate the consequences of the mixed straddle, temporary regulations provided for a purging of all gain or loss on the mixed straddle positions immediately prior to the establishment of the mixed straddle.[17] This purging was accomplished by requiring a taxpayer to recognize all gain or loss on a position that was held prior to the establishment of the mixed straddle immediately prior to the time that the position becomes part of a mixed straddle. These rules follows a direction in the legislative history to the mixed straddle rules in which Congress specifically provided that "pre-straddle gains and losses accrued at the time the mixed straddle is created [will] be recognized at such time."[18]

Given that the mixed straddle regulations do not provide that the straddle must be in place for any given period of time, certain taxpayers have reported pre-straddle gain or loss when entering into an identified mixed straddle that would be in place for a short period of time. In order to minimize price volatility on the Section 1256 position, taxpayers have used futures contracts over short dated debt instruments to enter into mixed straddles with respect to long-dated bonds. On mixed straddle accounts, certain taxpayers have reported that all gain and loss on a bond portfolio has been triggered when the Section 1256 position relates to less than all of the bonds in the account.[19]

The 2013 Proposed Regulations and a Congressional View of the Problem

In August 2013, the IRS proposed to reverse its rules that follow the Congressional mandate to cause taxpayers to recognize all gain or loss on positions that become part of an identified mixed straddle.[20] Specifically, in REG-112815-12 (August 2, 2013), the IRS determined that the ability to recognize gain or loss on the positions that comprise an identified mixed straddle allows taxpayers "to selectively recognize gains and losses in inappropriate circumstances and without market constraints." The regulations were proposed to be effective as of August 1, 2013. Correlative temporary regulations, issued at the same time, provided that pre-straddle gains and losses would be recognized under the rules that would apply to such gains and losses as if the identified mixed straddle had not been established.[21] Although there was no direct mention of the constructive sales rules, the proposed regulations did not override any other rules in the Code or regulations.

The proposed regulations did not apply to mixed straddle accounts.

The proposed regulations would have devastated the tax planning for insurance companies. Specifically, insurance companies hold long-term bonds, frequently until maturity. The financial crisis of 2008 and 2009 resulted in substantial losses on the bond portfolios of many insurance companies. Regulators would force the insurance companies to sell the loss positions, generating capital losses. The insurance companies, however, could not recognize gains on bonds that have appreciated because such bonds could not be sold by the insurers without regulatory disruption. In order to match the recognized capital losses with the unrecognized capital gains, when the insurance companies entered into hedges of the bonds, they would frequently create mixed straddles.

The creation of the mixed straddles allowed the insurance companies to unlock these built-in

gains. In order preserve this tax planning opportunity, representatives of the insurance industry lobbied the IRS to preserve the existing rules.[22] The IRS responded by changing the proposed effective date of the proposed regulations from a retroactive date of August 1, 2013 to the date that is 30 days after the promulgation of final regulations.[23]

Interestingly, in its tax reform efforts, Congress appears to be much more sympathetic to the plight of the insurance industry than is the IRS. Specifically, the tax reform proposals made by Rep. Dave Camp (R-MI), former Chairman of the House Ways & Means Committee, would alleviate the character mismatch challenge for insurance companies beginning in 2015 by allowing insurance companies to treat debt instruments as ordinary property assets for hedge purposes only.[24] As a result, gains and losses on bond hedging transactions would be treated as ordinary, even though the bond would remain a capital asset in the hands of the insurance company.

The Final IRS Regulations on Identified Mixed Straddles

On July 17, 2014, the IRS promulgated final regulations regarding identified mixed straddles.[25] The final regulations, published in the *Federal Register* on July 18, 2014, provide for an effective date 30 days after that, or August 16, 2014. The preamble to the final regulations specifically provides that following the original Congressional mandate of purging gains and losses on identified mixed straddles "undermines the realization requirements reject that generally govern gain and loss recognition." The final regulations provide limited relief for the insurance industry, however, by providing for a prospective effective date, as promised in October 2013. Thus, the final regulations will allow insurance companies with built-in gains on existing bond positions to use identified mixed straddle elections to trigger such gains until August 16, 2014.

Technically, new Treasury Regulation § 1.1092(b)-6(a) provides that "unrealized gain or loss on the day prior to the day the identified mixed straddle is established with respect to such position or positions is taken into account at the time, and has the character, provided by the provisions of the Internal Revenue Code that would apply to the gain or loss if the identified mixed straddle were not established." Treasury Regulation § 1.1092(b)-6(b) provides that the holding period "killer" rule applies to the mixed straddle itself.[26] The loss disallowance rule operates with respect both to unrecognized gain existing before the straddle is created as well as gain accrued during the existence of the identified mixed straddle.[27]

As was the case with the 2013 proposed regulations, the new rules on pre-straddle gains and losses do not apply to mixed straddle accounts.

The new final regulation is illustrated by several examples, but all of the examples ignore (or assume away) the application of the constructive sales rules. In the first example, a taxpayer holding a depreciated position in a Section 1256 contract identifies the Section 1256 contract as part of an identified mixed straddle. The example concludes that the built-in loss in the Section 1256 is recognized on the last day of the year. The example assumes that there is no change in value of the Section 1256.[28]

In a second example, a taxpayer holds an appreciated non-Section 1256 position that has a short-term holding period prior to the establishment of an identified mixed straddle. The identified mixed straddle is in place for a period that, when combined with the taxpayer's pre-identified mixed straddle holding period, meets the long-term capital gain holding period. When the identified mixed straddle is terminated, the non-Section 1256 contract is disposed of. Since the taxpayer could not add the holding period during which the identified mixed straddle was in effect to its holding

period, the example concludes that the gain from the disposition of the non-Section 1256 position is a short-term gain.

A third example in the regulations finesses the constructive sales issue by positing that the identified mixed straddle is terminated prior to the 30th day of the succeeding tax year.[29] (More on this below.)

The Constructive Sales Rules

By 1997, Congress had become concerned that certain transactions, including the use of forward contracts to sell already-owned stock, "did not result in the recognition of gain by the taxpayer."[30] In response to a number of well-publicized transactions in which taxpayers made use of planning techniques to monetize equity positions without current tax, Congress added Section 1259 (sometimes referred to as the "constructive sales rules") to the Code. In general, Code § 1259 requires that a taxpayer recognize gain, but not loss, upon entering into a "constructive sale" of an "appreciated financial position" in an amount equal to the amount of gain that would have been recognized if the position had been sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. An "appreciated financial position" is defined as any position with respect to stock, certain debt instruments, or partnership interests if there would be gain if the position were sold, assigned or otherwise terminated at its fair market value.[31]

The constructive sales rules do not apply to positions in "plain vanilla" debt instruments. A debt instrument is exempt from the constructive sales rules if it unconditionally entitles a holder to a specified principal amount, interest is payable on the debt instrument at a fixed rate or at a qualified variable rate and the debt is not convertible into stock of the issuer.[32] The constructive sales rules also do not apply to hedges of positions in plain vanilla debt instruments.[33] For this purpose, positions include interest in future contracts, short sales and options.[34] The constructive sales rules do not apply to positions that are subject to mark-to-market treatment.[35] The constructive sales rules also do not apply to positions in non-marketable securities that are settled within one year.[36]

Code § 1259(c) provides that a constructive sale of an appreciated financial position takes place, *inter alia*, if the taxpayer enters into a short sale of the same or substantially identical property or a futures or forward contract to deliver the same or substantially identical property. For purposes of the constructive sales rules, a forward contract results in a constructive sale of an appreciated financial position only if the forward contract provides for delivery of a substantially fixed amount of property for a substantially fixed price.[37] Although the statute does not offer any guidance with respect to what constitutes a "substantially fixed amount of property," the Senate Committee Report accompanying the constructive sale rules provides that a forward contract that provides for "significant" variation in the amount of property to be delivered does not result in a constructive sale.[38]

The constructive sales rules provide an exception for certain closed transactions.[39] Specifically, a constructive sale will be ignored if the transaction is closed before the 30th day of the succeeding tax year and the taxpayer holds the appreciated financial position unhedged for at least 60 days thereafter. (Hedges are permitted, provided that they are removed by the 30th day of the subsequent taxable year.[40])

Interaction of the New Identified Mixed Straddle Regulation and the Constructive Sales Rules

Many identified mixed straddle transactions will result in constructive sales. To the extent of this overlap, taxpayers that enter into identified mixed straddles will trigger the gain inherent in the non-Section 1256 contract position by reason

of entering into the identified mixed straddle. Taxpayers who enter into identified mixed straddle transactions with respect to appreciated Section 1256 contracts should not be affected by the constructive sales rules because these rules specifically carve-out positions that are subject to mark-to-market treatment. Accordingly, the timing rule illustrated in Treasury Regulation § 1.1092(b)-6(d)(Ex. 1) would apply even if the Section 1256 contract in that example referenced as asset potentially subject to the mark-to-market rules.

In addition, insurance companies desiring to trigger gain inherent in their bond portfolios are unlikely to be able to make affirmative use of the constructive sales rules. As recited above, the constructive sales rules do not apply to "plain vanilla" debt instruments. A significant portion of the bond portfolios of insurance companies are likely to be composed of debt instruments that are within this definition.

For all other taxpayers, however, the mixed straddle rules will become a "heads I win, tails you lose" proposition because of the constructive sales overlap. For taxpayers holding appreciated financial positions who enter into identified mixed straddles, gain will be triggered, but loss will be deferred. Taxpayers who desire to avoid this predicament will be required to terminate their identified mixed straddles before the 30th day of the succeeding tax year to take advantage of the statutory exception for closed transactions. Otherwise, the use of the identified mixed straddle rules will remain a one-way proposition. u

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Endnotes

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[2] Code § 1092(a)/

[3] Code § 1092(d)(7)(B),

[4] Treas. Reg. § 1.1092(d)-1(b)(1)(vii).

[5] Treas. Reg. § 1.1092(d)-1(b)(1)(I)(i), (ii).

[6] *See* Staff of the Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981*, p. 282.

[7] *See* Code § 1092(a)(1).

[8] Temp. Treas. Reg. § 1.1092(b)-5T(e).

[9] Code § 1256(b)(1).

[10] Code § 1256(a)(1), (3).

[11] It is worth noting that the definition of a mixed straddle in Code § 1256(d)(4) is not identical to the definition of a mixed straddle in Temp. Treas. Reg. § 1.1092(b)-5T(e). The IRS had specific authority to create this disparate treatment. See Code § 1092(b)(2)(C).

[12] Temp. Treas. Reg. § 1.1092-1T(a)(1); F.S.A. 1993-664.

[13] Temp. Treas. Reg. § 1.1092(b)-2T(b)(2).

[14] Temp. Treas. Reg. § 1.1092(b)-3T (rules for mixed straddles, determined on a straddle-by-straddle basis); Temp. Treas. Reg. § 1.1092(b)-4T (rules for mixed straddle accounts).

[15] Temp. Treas. Reg. § 1.1092(b)-3T(a).

[16] Temp. Treas. Reg. § 1.092-4T(b)(1).

[17] Temp. Treas. Reg. § 1.1092(b)-3T(b)(6) (straddle-by-straddle rule); Temp. Treas. Reg. § 1.1092-4T(c)(5).

[18] H.R. Rep. No. 98-861, 98th Cong., 2nd Sess. 912 (1984).

[19] *See* Sheppard, *Trouble with Mixed Straddle Regulations*, Tax Notes (October 28, 2013).

[20] T.D. 9627, 2013-35 I.R.B., REG-112815-12 (Aug. 1, 2013).

[21] Temp. Treas. Reg. § 1.1092-6T, as promulgated by T.D. 9627 (August 1, 2013).

[22] *See* Letter to Messrs. Mark J. Mazur and William J. Wilkins of the Treasury and IRS, respectively, Re: Public Comments on Temporary and Proposed Identified Mixed Straddle Regulations, from PriceWatershouseCoopers (September 12, 2013), reprinted at Tax Analysts, Document No. 2013-22030.

[23] RIN 1545–BK99 (FR Doc. 2013–25360 Filed Oct. 25, 2013).

[24] Prop. Code § 1221(b)(4).

[25] T.D. 9678 (July 17, 2014).

[26] See Temp. Treas. Reg. § 1.1092(b)-2(a)(1).

[27] Treas. Reg. § 1.1092-6(c).

[28] Treas. Reg. § 1.1092(b)-6(d)(Ex. 1)

[29] Treas. Reg. § 1.1092(b)-6(d)(Ex. 3)

[30] See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997*, p. 173 (December 17, 1997).

[31] Code § 1259(b)(1).

[32] Code § 1259(b)(2)(A).

[33] Code § 1259(b)(2)(B).

[34] Code § 1259(c)(3).

[35] Code § 1259(b)(2)(C).

[36] Code § 1259(c)(2).

[37] Code § 1259(d)(1).

[38] S. Fin. Rep. No. 105-33, 105th Cong., 1st Sess. 125-6 (1997).

[39] Code § 1259(c)(3)(A).

[40] Code § 1259(c)(3)(B).