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August 25, 2005

The Honorable Chuck Grassley
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Max Baucus
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

RE: Comments to Tax Technical Corrections Act of 2005 (S. 1447, H.R. 3376) -
IRC Section 1092 - Stock Exception to the Straddle Rule

Dear Chairman Grassley and Senator Baucus:

We are pleased to submit our written public comment in response to your request for comments related to the "Tax Technical Corrections Act of 2005" (H.R. 3376, S. 1447) (the "Technical Correction"). We believe the bill clarifies certain aspects of the Jobs Creation Act of 2004 (the "Act"), and offers both practitioners and taxpayers a more reliable framework for the application of the Act. Although the bill is certainly an improvement, we believe that an additional clarification in the Technical Correction would further enhance the reliability of the Act.

PRE-ACT RULES

Of particular concern is the repeal of the "stock exception to the straddle rule." In their day-to-day operations, our clients, and a multitude of other taxpayers, enter into long and short positions, some of which are structured to minimize risk. Section 1092(a)(1)(A) of the Internal Revenue Code, in pertinent part, provides that a loss with respect to a position shall be taken into account only to the extent that the amount of such loss exceeds the unrecognized gain with respect to one or more offsetting positions. This is referred to as the "loss deferral" straddle rule; this rule defers losses on the unwinding of the loss leg of a straddle. The straddle rule has other implications as well, including suspension of the holding period on property for purposes of determining long-term or short-term holding periods. Interest costs incurred on a straddle position must also be capitalized rather than being deducted as a current expense.

For these rules to apply, there, first and foremost, must be a straddle. Section 1092(c)(1) defines a “straddle” as an “offsetting position with respect to personal property”. In general, before the adoption of the Act, the term “personal property” did not include stock except under certain limited circumstances. One such circumstance, resulting in a “straddle” under old section 1092(d)(3), was a position in stock, the offsetting position of which was one with respect to substantially similar or related property (other than stock). The aforementioned circumstance, also known as the “stock exception to the straddle rule”, was interpreted by many practitioners to mean that a position in stock would not constitute “personal property” as long as such position was offset by another position in respect to the same or similar stock. This meant, for example, that if a taxpayer held a position in stock and an offsetting position in a short equity swap in the same or a similar stock, the stock would not be treated as “personal property”. This notion, however, changed with the introduction of proposed regulations section 1.1092(d)-2(c), which narrowed the initial interpretation of the statute to apply only to offsetting positions that were directly in stock or a short sale of stock. Consequently, if a taxpayer established a position in stock and an offsetting position in an equity swap in respect to the same stock, the stock would be treated as “personal property” because the offsetting position was not directly in stock or a short sale of stock.

POST-ACT RULES

The Act modified section 1092(d)(3)(A)(i) to read as follows: **“In the case of stock, the term ‘personal property’ includes stock only if-- (i) such stock is of a type which is actively traded and at least 1 of the positions offsetting such stock is a position with respect to such stock or substantially similar or related property” (emphasis added).** The presumed intended effect of this provision was to repeal the “stock exception to the straddle rule”. The conference report and the JCT 2004 explanations (the 2004 Blue Book) supports this intention, that “[t]he Act also eliminates the exception from the straddle rules for stock (other than the exception relating to qualified covered call options)”. Problematically, footnote 867 of the Conference Report states that, “[it] is intended that Treasury regulations defining substantially similar or related property for this purpose will continue to apply subsequent to repeal of the stock exception and generally will constitute the exclusive definition of a straddle with respect to offsetting positions involving stock. See Prop. Treas. Reg. sec. 1.1092(d)-2(b)”.

NEED FOR CLARIFICATION

The language of the new provision in the Act itself suggests that the “stock exception to the straddle rule” is repealed in its entirety. As such, a long position in stock offset by a

short position in the same stock, or a short position in a similar stock, should presumably lead to the classification as “personal property” and, hence, to a straddle. However, the underlying history behind the provision may lead to a different interpretation. As we suggest below, footnote 867 may be interpreted to stand for the proposition that the Act repeals only the stock exception in respect to short positions in the *same* stock, but not short positions in stock that is “substantially similar or related property” (“SSRP”).

The straddle rule was enacted in 1981 for the principal purpose of defeating certain shelter arrangements proliferating at that time by prohibiting the selective realization of losses. To accomplish this, the provision treats two ostensibly separate transactions as if they were one because of the interdependency of the economic relationships and because the taxpayer, but for the loss deduction, would not have changed his underlying economic position.

We believe the failure to clarify the scope of the repeal of the stock exception in the Technical Correction will create unnecessary burden and unintended consequences to taxpayers engaged in non-abusive transactions. For example, a taxpayer holding a long position in GE stock and a short position in a non-grantor trust regulated investment company (a “RIC”) holding some GE stock will have to determine under the SSRP regulations (Reg. §1.246-5, Prop. Regs. §1.1092(d)-2) whether the RIC is SSRP with respect to the GE stock, and based on that determination, whether the positions constitute a straddle under section 1092. Conceivably, for example, at the time the long GE position and the short RIC position were established, the RIC might not have held any GE stock, but might later acquire such GE stock in the ordinary course of business, under which circumstances the taxpayer may then be deemed to have an “unintended” or “unexpected” straddle. A RIC should not be treated the same as a synthetic hedging product. Rather, a RIC is a common non-abusive investment product which, because of its investment objectives and the independence of its investment advisors, makes it an unlikely candidate for tax arbitrage. The additional burden imposed by the Act on taxpayers holding short positions in RICs will outweigh the limited potential for abuse resulting from a taxpayer’s limited ability to selectively realize losses under these circumstances.

Footnote 867 also states that proposed regulations section 1.1092(d)-2 will constitute the exclusive definition of a straddle. Apart from the fact that the proposed regulations do not contain a definition of a straddle, the proposed regulations expressly provide that “a position with respect to substantially similar or related property (other than stock) does not include direct ownership of stock or a short sale of stock but includes any other position with respect to substantially similar or related property”. If, as the footnote suggests, the proposed regulations continue to be applicable, a short position in a “similar stock”(e.g. a short position in a non-grantor RIC), or a direct position in a “similar stock”

would not be a position in respect to “substantially similar or related property” for purposes of section 1092(d). Accordingly, the offset stock would not be “personal property.”

Because the proposed regulations do not provide an exception for short sales in the *same* stock, the new statute in combination with the proposed regulations should be interpreted to *only* repeal the stock exception in respect to short sales in the *same* stock, and to preserve the stock exception for short sales in “*similar or related*” stock. To interpret the legislative history and the statute otherwise would unduly burden taxpayers such as those holding short positions in RICs, with the duty to verify whether each long position they sell at a loss is a part of a straddle with respect to any such short RIC positions. Additionally, any position in a RIC provides limited, if any, potential for abuse through the selective realization of losses

For the reasons discussed above, we believe footnote 867 should be construed such that the Act repeals only the stock exception in respect to short positions in the same stock, and not short positions in stock that is “substantially similar or related property”.

RECOMMENDATION

We believe that Congress intended to resolve the previous ambiguity stemming from the old statute and the proposed regulations, and also intended to repeal the stock exception to the straddle rule with respect to short sales *in the same* stock, but not short sales in similar or related property such as stock similar to the offset stock. Thus, section 1092(d)(3)(A)(i) should be corrected to unambiguously reflect the intent of Congress. We suggest the following language clarification be included in the Technical Correction (clarification in **bold**):

(3) Special Rules For Stock- For purposes of paragraph (1)--

(A) In General- In the case of stock, the term ‘personal property’ includes stock only if--

(i) such stock is of a type which is actively traded and at least 1 of the positions offsetting such stock is a position with respect to such stock or substantially similar or related property (**other than stock**), or

(ii) such stock is of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.

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This language, in conjunction with the proposed regulations, unambiguously states that if the offsetting position is in the same stock, or similar or related property other than a direct ownership of stock or a short sale of stock, the stock will be treated as “personal property”.

We are pleased to have been able to offer this comment, and we hope that it will help in clarifying the intent of Congress in respect to the repeal of the stock exception in section 1092. Please do not hesitate to contact us should you have any questions regarding this comment.

Sincerely,

Michael Kosnitzky

cc: Keith J. Blum, Esq
Ivan N. Mitev