INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

May 1, 2000

Number: **200033004**
Release Date: 8/18/2000
Index (UIL) Nos.: 1092.06-00, 1092.07-00
CASE MIS No.: TAM-117588-99/CC:DOM:FI&P:B3

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's ID No.:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Number1 =

Year1 =
Year2 =

Date1 =
Date2 =
Date3 =
Date4 =
Date5 =
Date6 =
Date7 =

ISSUES:

(1) For purposes of the special rule for stock in § 1092(d)(3)(B)(i)(II) of the Internal Revenue Code, does § 1.1092(d)-2(a) of the Income Tax Regulations apply to provide that the phrase "substantially similar or related property" is defined in § 1.246-5 when that phrase is applied retroactively under the effective date rule in § 1.1092(d)-2(b)(2) (and the phrase is not defined by the "mimics" standard in § 1.1092(d)-2(b)(2))?

(2) Section 1092(c)(4)(A) of the Internal Revenue Code provides an exception from straddle treatment for offsetting positions consisting of qualified covered call options and the optioned stock. Taxpayer holds a portfolio of stocks for which Taxpayer has sold listed call options on certain of the stocks in the portfolio which would be qualified covered call options under

§ 1092(c)(4)(A) but for the possible existence of a larger straddle. Taxpayer has hedged against general market risk by purchasing listed put options on S&P 500 index futures contracts. The portfolio does not satisfy the "substantial overlap" test of § 1.246-5 with respect to the put options. Is the determination whether the put options create a larger straddle with respect to the call options and the optioned stock made on a stock-by-stock basis?

CONCLUSIONS:

(1) Yes. The effective date rule in § 1.1092(d)-2(b)(2) causes the application of § 1.1092(d)-2(a) and thereby the application of § 1.246-5. Thus, Taxpayer's stock portfolio and put options on S&P 500 stock index futures contracts do not constitute a straddle (using § 1092(d)(3)(B)(i)(II)) unless the "substantial overlap" test of § 1.246-5 is satisfied.

(2) Yes. Under the circumstances described in the issue, the existence of a larger straddle is tested on a stock-by-stock basis rather than for the portfolio in the aggregate. Thus, the determination whether there are offsetting positions under § 1092(c)(2) is made only for Taxpayer's put options on the S&P 500 stock index futures contracts and for positions consisting of the individual stocks on which Taxpayer sold call options.

FACTS:

Taxpayer is a large mutual property and casualty insurance company.

In Year1, Taxpayer owned a diversified portfolio of common stocks of unaffiliated domestic companies (the "Portfolio"). In Year1 and Year2, Taxpayer owned approximately Number1 of the 500 stocks included in the S&P 500 index.

Taxpayer entered into various option transactions to hedge against a possible decline in the stock market. On Date1, Taxpayer purchased listed put options on S&P 500 stock index futures contracts (the "Index Put Options"). The Index Put Options ran from Date1, until Date2.

Taxpayer sold listed call options on S&P 500 stock index futures contracts (the "Index Call Options"). The Index Call Options were 3- to 5-month contracts that generally were in place from Date3, until Date2.

Taxpayer also sold listed call options on various individual stocks in the Portfolio (the "Covered Call Options"). As Covered

Call Options were closed out due to expiration or sales of the underlying securities, new Covered Call Options were sold. The Covered Call Options were generally in place from Date4 until Date5.

The Index Put Options and Index Call Options will be referred to as the "Index Options." The Index Options and the Covered Call Options will be referred to as the "Options."

On its amended Year1 federal income tax return and its Year2 federal income tax return, Taxpayer took the position that the Options were not subject to the loss deferral rules of § 1092. Accordingly, Taxpayer deducted the full amounts of losses realized with respect to the expiration or early termination of Covered Call Options. Taxpayer also deducted losses for Index Put Options that were marked to market and included gains for Index Call Options that were marked to market.

The Revenue Agent took the position that some or all of the stock in the Portfolio and some or all of the Options constituted straddles to which the loss deferral rules of § 1092 applied. The Revenue Agent's primary argument was that the stock in the Portfolio and the Index Put Options constituted a straddle. This argument depended on a reading of § 1.1092(d)-2(b)(2) according to which the determination whether the stock underlying the Index Put Options (the S&P 500 index) constituted "substantially similar or related property" with respect to the Portfolio should be made using the "mimics" standard in § 1.1092(d)-2(b)(2) rather than the "substantial overlap" test in § 1.246-5. The Revenue Agent's secondary argument was that the Covered Call Options, the optioned stock, and an "allocable portion" of the Index Put Options constituted a straddle. This argument depended on the permissibility of treating the portion of the Index Put Options relating to the optioned stock as a "position" for purposes of § 1092(d)(2).[1]

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[1] The Revenue Agent implicitly argued that the "allocable portion" of the Index Put Options would cause the optioned stock to qualify as personal property under § 1092(d)(1) through the application of § 1092(d)(3)(B)(i)(I). That was unnecessary, however, because the optioned stock is tentatively assumed to be personal property when testing for the existence of a larger straddle under § 1092(c)(4)(A)(ii). With respect to a possible larger straddle, we find no support for the proposition that the portion of an option or futures contract on a stock index corresponding to a stock portfolio can be separated and treated as a position for purposes of § 1092(d)(2).

A presubmission conference was held on Date6. Taxpayer and the Revenue Agent were advised that failure to respond to an argument by the other side would be treated as an admission of the argument. As a result of that policy, several arguments have been accepted for purposes of this memorandum. Those arguments are described in the following paragraph.

The Revenue Agent argued without rebuttal that the Portfolio and the Index Put Options satisfy the "mimics" standard of § 1.1092(d)-2(b)(ii). Taxpayer argued without rebuttal that the Index Put Options do not constitute "substantially similar or related property" with respect to the Portfolio as that phrase is defined by the "substantial overlap" test in § 1.246-5 (through the application of § 1.1092(d)-2(a)), that the Covered Call Options are "qualified covered call options" for purposes of § 1092(c)(4)(A) unless the call options and the optioned stocks are part of a larger straddle, and that the "larger straddle" in § 1092(c)(4)(A)(ii) must include another straddle in addition to the smaller straddle.

An adverse conference was held by telephone on Date7. Taxpayer conceded that for purposes of the exception for straddles consisting of qualified covered call options and the optioned stock in § 1092(c)(4)(A), the existence of a "larger straddle" is tested under the assumption that the optioned stock is "personal property" as defined in § 1092(d)(1) because of the application of § 1092(d)(3)(B)(i)(I). Taxpayer argued, however, that the existence of a larger straddle involving the Index Put Options and the optioned stock should be tested only on a stock-by-stock basis.

LAW:

Section 1092(c)(1) provides that the term "straddle" means offsetting positions with respect to personal property.

Section 1092(c)(2)(A) provides generally 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 one or more other positions with respect to personal property (whether or not of the same kind).

Section 1092(d)(1) provides that the term "personal property" means any personal property of a type that is actively traded.

Section 1092(d)(3)(A) provides that the term "personal property" generally does not include stock. Section

1092(d)(3)(B)(i)(I) and (II), however, provide that the term "personal property" does include stock that is part of a straddle at least one of the offsetting positions of which is (I) an option with respect to such stock or substantially identical stock or securities, or (II) under regulations, a position with respect to substantially similar or related property (other than stock).

Section 1092(c)(4)(A) provides that offsetting positions that would otherwise be a straddle shall not be treated as a straddle if all the offsetting positions making up the straddle consist of one or more qualified covered call options and the stock to be purchased from the taxpayer under such options, and the straddle is not part of a larger straddle. (Section 1092(c)(4)(B) defines the term "qualified covered call option.")

> (A) IN GENERAL.--If--
> (i) all the offsetting positions making up any straddle consist of 1 or more qualified covered call options and the stock to be purchased from the taxpayer under such options, and
> (ii) such straddle is not part of **a larger straddle**,
> such straddle shall not be treated as a straddle for purposes of this section and section 263(g). [Emphasis supplied.]

Section 246(c)(4)(C) provides that the holding periods for stock determined for purposes of § 246(c) shall be appropriately reduced for any period in which, under regulations, a taxpayer has diminished his risk of loss by holding one or more positions with respect to substantially similar or related property.

Section 1.1092(d)-2(a) provides that for purposes of § 1092(d)(3)(B), the term "substantially similar or related property" is defined in § 1.246-5. (Section 1.246-5(c) applies the "substantial overlap" test to positions that reflect the value of a portfolio of stocks.) The effective date rules for § 1.1092(d)-2 are contained in § 1.1092(d)-2(b):

> (b) Effective date--(1) In general. **This section** applies to positions established on or after March 17, 1995.
> (2) Special rule for certain straddles. **This section** applies to positions established after March 1, 1984, if the taxpayer substantially diminished its risk of loss by holding substantially similar or related property involving the following types of transactions–

> (i) Holding offsetting positions consisting of stock and a convertible debenture of the same corporation where the price movements of the two positions are related; or
>
> (ii) Holding a short position in a stock index regulated futures contract (or alternatively **an option on such a regulated futures contract** or an option on the stock index) and stock in an investment company whose principal holdings mimic the performance of the stocks included in the stock index (or alternatively **a portfolio of stocks whose performance mimics the performance of the stocks included in the stock index**). [Emphasis supplied.]

Section 1.1092(b)-4T(b)(3) includes an example that assumes that the stock of each of three corporations constitutes an offsetting position with respect to options on a broad-based stock index futures contract.

The conference report to the Tax Reform Act of 1984 explained regarding § 1092(d)(3)(B)(i)(II) that:

> Offsetting positions, one of which is actively traded stock or an interest in such stock and one of which is a position in substantially similar or related property (other than stock) as determined under regulations, constitute a straddle subject to the loss deferral rule and other straddle rules, under the conference agreement. ... [T]he conferees intend that the regulations defining positions that are substantially similar or related to stock held by the taxpayer will apply to straddles described in the following paragraph only for positions established on or after March 1, 1984, and for positions not described in the following paragraph only on a prospective basis.
>
> A straddle consisting of stock and substantially similar or related property includes offsetting positions consisting of stock and a convertible debenture of the same corporation where the price movements of the two positions are related. It also includes a short position in a stock index RFC (or alternatively **an option on such an RFC** or an option on the stock index) and stock in an investment company whose principal holdings mimic the performance of the stocks included in the stock index (or alternatively **a portfolio of stocks whose performance mimics the performance of the stocks included in the index**). [Emphasis supplied.]

H.R. Conf. Rep. No. 98-861, at 907 (1984).

The conference report to the Tax Reform Act of 1984 also explained regarding § 246(c)(4) that:

> The substantially similar standard is not satisfied merely because the taxpayer (1) holds a single instrument that is designed to insulate the holder from market risks (e.g., adjustable rate preferred stock that is indexed to the Treasury bill rate), or (2) is an investor with diversified holdings and acquires an RFC or an option on a stock index to hedge general market risks.

H.R. Conf. Rep. No. 98-861, at 818 (1984).

ANALYSIS:

Issue (1)

There are two plausible interpretations of § 1.1092(d)-2(b) as it applies to a pair of positions such as the Portfolio and the Index Put Options as in this case.

Under the first interpretation, the positions are tested under the "substantial overlap" test of § 1.246-5 (via § 1.1092(d)-2(a)) if they are established on or after March 17, 1995, but they are tested under the "mimics" standard of § 1.1092(d)-2(b)(2)(ii) (and not under § 1.246-5) if they are established after March 1, 1984, and before March 17, 1995.

Under the second interpretation, the positions are tested under the "substantial overlap" test of § 1.246-5 if they are established on or after March 17, 1995. They are also tested under § 1.246-5 if they are established after March 1, 1984, and before March 17, 1995, but only if they satisfy the "mimics" standard of § 1.1092(d)-2(b)(2)(ii). Thus, the "mimics" standard is merely a threshold test for the congressionally directed retroactive application of the "substantial overlap" test.

We believe that we are compelled to adopt the second interpretation because the first interpretation conflicts with established Internal Revenue Service usage of the phrase "this section." Under this established usage, the occurrences of the phrase "this section" in § 1.1092(d)-2(b)(1) and (2) must both refer to § 1.1092(d)-2 and thus invoke the operational rule in § 1.1092(d)-2(a). If the drafters had intended that the occurrence of "this section" in § 1.1092(d)-2(b)(2) refer to that paragraph (b)(2), they would have used the phrase "this paragraph (b)(2)."

In addition to the argument based on established usage, there are several reasons to prefer the second interpretation to the first interpretation. The first reason is that the first interpretation requires inconsistent readings of the phrase "this section" in subparagraphs (b)(1) and (b)(2). In subparagraph (b)(1), the phrase must be read to refer to subsection (a), whereas in subparagraph (b)(2), the phrase must be read to refer to subparagraph (b)(2). On the other hand, the second interpretation consistently reads the phrase to refer to § 1.1092(d)-2 and its operative rule in subsection (a).

The second reason is that the first interpretation must disregard the fact that subparagraph (b)(2) uses the phrase "substantially similar or related property," which it is supposedly defining. This is not a problem for the second interpretation, because it does not consider subparagraph (b)(2) to be a definitional rule. The second interpretation considers the "mimics" standard to be a threshold test for application of the definition in subsection (a).

The third reason is that the first interpretation allows the phrase "substantially similar or related property" to have different meanings for positions that are identical except that one was established before March 17, 1995, and the other was established on or after March 17, 1995. The conference report, however, contains no such instruction. To the contrary, it suggests that all positions that are established after March 1, 1984, and that meet the "mimics" standard should be subject to the same definition. Thus, the first interpretation implies that the regulations do not implement congressional intent.

The fourth reason is that the first interpretation renders § 1.1092(d)-2 ambiguous. Under the first interpretation, it is not clear which definition applies to a position that satisfies the "mimics" standard but was established on or after March 17, 1995. Paragraphs (b)(1) and (b)(2) both apply, and the regulation does not resolve the ambiguity. This is not a problem for the second interpretation, because it applies the same definition in any event and considers the "mimics" standard to be a threshold test for retroactivity.

The fifth reason is that the first interpretation implies that the regulations fail to implement congressional intent to provide a definition that includes certain specified positions. It is apparent that Congress wanted the regulations to provide a definition. Under the first interpretation, however, for positions established after March 1, 1984, and before March 17, 1995, the regulations provide no definition but merely recapitulate the requirements Congress placed on the definition.

This is not a problem for the second interpretation, because it applies the same regulatory definition to positions established during the retroactive period.

Issue (2)

The legislative history of § 246(c)(4) indicated that the "substantially similar" standard would not be met by a taxpayer with a diversified stock portfolio who acquired a regulated futures contract or an option on a stock index to hedge against general market risk. Such a taxpayer has surely diminished his risk of loss by holding that position in addition to his stock. Thus, the legislative history must be read to say that such diminution is not a kind of diminution for which Congress wished to trigger a reduction in holding periods or is of insufficient magnitude to trigger such a reduction.

The congressional determination that hedging against general market risk through the use of options on a stock index does not warrant a reduction in holding periods under § 246(c) because the diminution of risk of loss either is not of an abusive kind or is of insufficient magnitude implies at least that such a diminution might not be a "substantial diminution" for purposes of § 1092(c)(2)(A).

We have found no explanation for the fact that the favorable statement regarding diminution of general market risk was found only in the § 246 legislative history and not also in the § 1092 legislative history. Thus, we are inclined to view diminution of general market risk favorably for purposes of § 1092, but only in those cases where it is most clearly appropriate to do so.

Especially in light of § 1.1092(d)-2, the exception for hedges of stock portfolios against general market risk using options on stock indexes or futures contracts on stock indexes must be limited, at the least, to cases in which there is no diminution of risk of loss specific to the portfolio. Thus, the exception is not available if the portfolio satisfies the "substantial overlap" test of § 1.246-5 with respect to the option. In addition, the exception is not available if the option is in any way tailored to the portfolio. This "no tailoring" requirement is more likely to be met if the option is a listed option.

Our understanding of the economics of Taxpayer's transactions is that Taxpayer purchased the Index Put Options to protect the Portfolio from general market risk. The Portfolio not only did not meet the "substantial overlap" test in § 1.246-5 but was very far from meeting it. Taxpayer wrote the Index Call Options and the Covered Call Options in order to use the premiums

it received on those calls to offset, or largely offset, the premiums it paid to purchase the Index Put Options. Writing calls on individual stocks in the Portfolio was less risky than writing calls on S&P 500 futures contracts because it was possible that the S&P 500 would rise by more than the individual stocks in Taxpayer's portfolio.

Thus, there is no relation between the Index Put Options and the Covered Call Options beyond the fact that the premiums received on the Covered Call Options were intended to offset the premiums paid to purchase the Index Put Options. This is very different from a case in which a taxpayer purchases puts and writes calls on the same individual stock, where those calls would certainly be part of a larger straddle and thus would not be qualified covered calls under § 1092(c)(4).

Section 1.1092(b)-4T(b)(3) includes an example that assumes that the stock of each of three corporations constitutes an offsetting position with respect to options on a broad-based stock index futures contract. That example thus implicitly provides that the determination is made for each stock rather than for the three stocks collectively.

Thus, while the matter is not at all clear, we conclude that under the facts of this case, the existence of a larger straddle with respect to the Covered Call Options and the optioned stock is tested against the Index Put Options on a stock-by-stock basis.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) provides that it may not be used or cited as precedent.