Section 1259.—Constructive Sales Treatment for Appreciated Financial Positions

Constructive sales; reestablished positions. This ruling provides guidance on the interaction between section 1259(c)(3)(A) of the Code (exception for certain closed transactions) and section 1259(c)(3)(B) (treatment of positions which are reestablished).

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ISSUE

If a taxpayer enters into successive short sales of its entire appreciated financial position, must the taxpayer recognize gain pursuant to § 1259(a)(1) of the Internal Revenue Code if all of the short sales are closed before the 30th day after the end of the taxpayer's taxable year and the entire appreciated financial position is held unhedged for a 60-day period beginning on the date on which the last of the short sales is closed?

FACTS

A is a calendar year taxpayer. On January 1, 2002, *A* owns 100 shares of stock in *X* Corporation (*X* stock). On February 1, 2002, *A* enters into a short sale of 100 shares of *X* stock (Short Sale 1). In March of 2002, *A* purchases an additional 100 shares of *X* stock and delivers those shares to close Short Sale 1. On April 1, 2002, *A* enters into a second short sale of 100 shares of *X* stock (Short Sale 2). In May of 2002, *A* purchases an additional 100 shares of *X* stock and delivers those shares to close Short Sale 2. On June 3, 2002, *A* enters into a third short sale of 100 shares of *X* stock (Short Sale 3). On January 15, 2003, *A* purchases an additional 100 shares of *X* stock. Prior to the deadline contained in § 1259(c)(3)(B)(ii)(II), *A* delivers those shares to close Short Sale 3. *A* continues to hold the 100 shares of *X* stock during the 60-day period beginning on the date Short Sale 3 is closed. At all relevant times during that period, *A*'s risk of loss with respect to the 100 shares of *X* stock is not reduced by reason of a circumstance described in § 1259(c)(3)(A)(iii). That is, the 100 shares of *X* stock are held "unhedged" during the 60-day period. At all relevant times, the 100 shares of *X* stock are appreciated.

LAW

Section 1259(a)(1) provides that if there is a constructive sale of an appreciated financial position (AFP), the taxpayer must recognize gain as if the position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. "Appreciated financial position" is defined in § 1259(b)(1) to include a position with respect to stock if there would be gain were the position sold, assigned, or otherwise terminated at its fair market value. Section 1259(c)(1)(A) treats a taxpayer as having made a constructive sale of an AFP if the taxpayer enters into a short sale of the same or substantially identical property.

Section 1259(c)(3)(A) provides an exception (closed transaction exception) to § 1259(a)(1) for certain closed transactions. The closed transaction exception disregards any transaction that would otherwise be treated as a constructive sale during the taxable year if: (i) the transaction is closed before the end of the 30th day after the close of the taxable year; (ii) the taxpayer holds the AFP throughout the 60-day period beginning on the date the transaction is closed; and (iii) at no time during the 60-day period is the taxpayer's risk of loss with respect to the position reduced by reason of a circumstance that would be described in § 246(c)(4) if references to stock included references to the position. That is, the taxpayer must hold the AFP "unhedged" for a 60-day period beginning on the date of the closing of the transaction that would otherwise be treated as a constructive sale.

If certain requirements are met, even though a subsequent risk-reducing transaction would otherwise prevent the closed transaction exception from applying to some prior transaction, § 1259(c)(3)(B) may cause the subsequent transaction to be disregarded for this purpose. In general, this rule (the reestablished positions exception) applies when a taxpayer closes out a transaction (the prior transaction) that would otherwise cause a constructive sale of an AFP and, during the 60-day period following the closing of the prior transaction, the taxpayer enters into a substantially similar transaction (the subsequent transaction) that, if not disregarded, would violate the "unhedged" 60-day period requirement with respect to the prior transaction. The requirements are: (i) the prior transaction is closed during the taxable year or during the 30 days thereafter; (ii) the subsequent transaction is substantially similar to the prior transaction and would otherwise cause a constructive sale of the AFP; (iii) the subsequent transaction is closed before the 30th day after the close of the taxable year in which the prior transaction occurs; and (iv) the 60-day unhedged requirements of § 1259(c)(3)(A)(ii) and (iii) are met with respect to the subsequent transaction.

ANALYSIS

Short Sale 1

Short Sale 1 is described in § 1259(c)(1) and is closed before the end of the 30th day after 2002. In addition, *A* holds the 100 shares of *X* stock for the 60-day period beginning on the date Short Sale 1 is closed. During part of the 60-day period beginning on the date Short Sale 1 is closed, however, *A*'s risk of loss with respect to *X* stock is reduced because *A* entered into Short Sale 2. Thus, Short Sale 1 fails the closed transaction exception unless the reestablished position exception causes Short Sale 2 to be disregarded.

Short Sale 2 is substantially similar to Short Sale 1, is entered into during the 60-day period beginning on the date Short Sale 1 is closed, is described in § 1259(c)(1) and is closed by the deadline contained in § 1259(c)(3)(B)(ii)(II). In addition, *A* holds the 100 shares of *X* stock for the 60-day period beginning on the date Short Sale 2 is closed. During the 60-day period beginning on the date Short Sale 2 is closed, however, *A*'s risk of loss with respect to *X* stock is reduced because *A* entered into Short Sale 3. Thus, the reestablished position exception does not cause Short Sale 2 to be disregarded unless the reestablished position exception also causes Short Sale 3 to be disregarded.

Short Sale 3 is substantially similar to Short Sale 2, is entered into during the 60-day period beginning on the date Short Sale 2 is closed, is described in § 1259(c)(1) and is closed by the deadline contained in § 1259(c)(3)(B)(ii)(II). In addition, *A* holds the 100 shares of *X* stock for the 60-day period beginning on the date Short Sale 3 is closed, and during the 60-day period beginning on the date Short Sale 3 is closed, *A*'s risk of loss with respect to *X* stock is not reduced. Accordingly, Short Sale 3 is disregarded as a reestablished position with respect to Short Sale 2, Short Sale 2 in turn is disregarded as a reestablished position with respect to Short Sale 1, and Short Sale 1, therefore, is treated as a closed transaction under § 1259(c)(3)(A).

Short Sale 2

The next question is whether Short Sale 2 causes a constructive sale or whether it too is disregarded for this purpose on the grounds that it is a closed transaction. The analysis supporting the application of that exception is similar to that for Short Sale 1. Short Sale 2 is described in § 1259(c)(1) and is closed before the end of the 30th day after 2002. In addition, *A* holds the 100 shares of *X* stock for the 60-day period beginning on the date Short Sale 2 is closed. During part of the 60-day period beginning on the date Short Sale 2 is closed, however, *A*'s risk of loss with respect to *X* stock is reduced because *A* entered into Short Sale 3. Thus, Short Sale 2 fails the closed transaction exception unless Short Sale 3 is disregarded as a reestablished position. As noted above, Short Sale 3 is disregarded as a reestablished position with respect to Short Sale 2. Therefore, Short Sale 2 is also a closed transaction under § 1259(c)(3)(A).

Short Sale 3

Short Sale 3 is described in § 1259(c)(1) and is closed before the end of the 30th day after 2002. In addition, *A* holds the 100 shares of *X* stock for the 60-day period beginning on the date Short Sale 3 is closed. During the 60-day period beginning on the date Short Sale 3 is closed, *A*'s risk of loss with respect to *X* stock is not reduced. Therefore, Short Sale 3 is a closed transaction under § 1259(c)(3)(A).

Rapid Series of Transactions

A entered into Short Sale 3 on June 3, 2002, more than 60 days after the date on which Short Sale 1 closed. If Short Sale 3 had occurred within that 60-day period, the analysis of Short Sale 1 would remain the same except that, for Short Sale 1 to be a closed transaction, Short Sale 3 would have to be a reestablished position not only with respect to Short Sale 2 but also with respect to Short Sale 1 directly. Thus, if *A* had entered into Short Sale 2 on March 15, 2002, closed Short Sale 2 on March 18, 2002, entered into Short Sale 3 on March 20, 2002, and closed Short Sale 3 on March 25, 2002, Short Sale 3 would qualify to be disregarded as a reestablished position with respect to Short Sale 1 as well as with respect to Short Sale 2.

Decline in Value of the AFP

Section 1259(c)(3)(B)(ii)(I) describes a subsequent transaction that may be disregarded as one "which also would otherwise be treated as a constructive sale of [the AFP]." For the reasons explained below, this provision requires only that the subsequent transaction be a transaction described in § 1259(c)(1) that would cause a constructive sale of the AFP if the subsequent transaction occurred on the date of entering into the prior transaction. This provision does not require that the subsequent transaction independently would cause a constructive sale based on appreciation in the position at the time the subsequent transaction occurs. Thus, the conclusion in this ruling that Short Sale 1 is a closed transaction under § 1259(c)(3)(A) would apply even if the 100 shares of *X* stock had declined in value below *A*'s basis at the time *A* entered into each subsequent transaction.

Requiring appreciation of the 100 shares of *X* stock owned by *A* at the time *A* enters into each subsequent transaction could cause Short Sale 1 to fail the closed transaction exception. For example, assume that on the date that *A* entered into Short Sale 3, the 100 shares of *X* stock still owned by *A* had declined in value below *A*'s basis. If § 1259(c)(3)(B)(ii)(I) required that the *X* stock be appreciated at that time, Short Sale 3 would fail to be a disregarded, reestablished position with respect to Short Sale 2. If Short Sale 3 were not disregarded, then Short Sale 2 would fail the no-risk-reduction requirement in § 1259(c)(3)(A)(iii), which would then cause Short Sale 2 to fail as a disregarded, reestablished position with respect to Short Sale 1.

Requiring appreciation when *A* enters into subsequent transactions would create several unwarranted results. First, in certain circumstances it would treat more favorably a taxpayer, *B*, who has a lower tax basis and, therefore, a larger amount of unrealized appreciation. Thus, if *B* holds appreciated *X* stock with a basis lower than that of *A* and enters into a series of transactions identical to those of *A*, and if the value of the 100 shares of *X* stock at the time of Short Sale 3 is higher than *B*'s basis but lower than *A*'s basis, then *A* would realize gain because of Short Sale 1 but *B* would not. Nothing in the statute or legislative history indicates that Congress intended this dissimilar treatment.

Second, requiring appreciation when *A* enters into subsequent transactions would treat *A* differently from a taxpayer, *C*, who enters into only Short Sale 1 and holds that short position open until the date Short Sale 3 is closed. Although *C* would have reduced risk for a longer period of time than *A*, Short Sale 1 would be a closed transaction that is not subject to § 1259(a) for *C* but would be subject to § 1259(a) for *A*. There also is nothing in the statute or legislative history indicating that Congress intended this dissimilar treatment.

Third, requiring appreciation when *A* enters into subsequent transactions would create circularity problems if the value of the AFP at the time of the later short sale is between the taxpayer's original basis in the AFP and the value of the AFP at the time of the first short sale. In these cases, whether the later short sale is a disregarded transaction would depend on whether the first short sale produced a basis increase as a result of causing a constructive sale to occur, which would depend, in turn, on whether the later short sale is disregarded. As a consequence, many reestablished positions would fail to meet the requirement that they would otherwise be treated as a constructive sale if the existence of unrealized appreciation in the position were tested on the date of the subsequent transaction and, for this purpose, the prior transaction were treated, at least provisionally, as causing a constructive sale. Failure to treat the prior transaction as causing a constructive sale, at least provisionally, would result in the reestablished position failing to meet the requirement that the prior transaction "would otherwise be treated as a constructive sale."

Consequently, ignoring changes in value of the AFP after the initial transaction occurs avoids unwarranted, differential application of the closed transaction exception and also avoids a potential circularity problem in the interpretation of the exception. When there is a series of more than two transactions, the foregoing analysis also applies to any of the intermediate transactions for purposes of determining whether the reestablished positions exception allows the intermediate transaction to benefit from the closed transaction exception.

HOLDING

Section 1259(c)(3)(A) applies to Short Sale 1, Short Sale 2, and Short Sale 3. Therefore, *A* does not recognize gain pursuant to § 1259(a)(1).

DRAFTING INFORMATION

The principal author of this revenue ruling is Kate Sleeth of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Ms. Sleeth at (202) 622–3920 (not a toll-free call).