

## **COMMENTS CONCERNING FORTHCOMING REGULATIONS REGARDING CONSTRUCTIVE SALES**

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The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Financial Transactions of the Section of Taxation. Principal responsibility was exercised by Paul Crispino and David Garlock. Substantive contributions were made David Weisbach, Matthew Stevens, and Paul Jacokes. The Comments were reviewed by Alfred C. Groff of the Committee on Government Submissions and by Steve Conlon, Council Director for the Committee on Financial Transactions.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Contact Person: Paul Crispino  
GE Asset Management Inc.  
Stamford, CT  
(203) 921-2140

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## I. Summary of Comments

Section 1259<sup>1</sup> requires taxpayers to recognize gain with respect to certain appreciated financial positions if the taxpayer engages in certain statutorily enumerated transactions that have the effect of eliminating substantially all of a taxpayer's risk of loss and opportunity for gain, so-called "constructive sales." Regulations can expand the definition of a constructive sale to include other transactions that have "substantially the same effect" as the statutorily enumerated transactions. In this report, we recommend that, to the greatest extent possible, the Treasury Department<sup>2</sup> provide objective standards for evaluating whether or not a transaction is a constructive sale. Specifically, this report contains the following primary recommendations:

- A relatively simple test should be used to evaluate whether a "costless collar" (or nearly costless collar) is a constructive sale, taking into account only the width and duration of the collar and not the volatility of the underlying stock or other financial position;
- A put option or a short call option on an appreciated financial position (but not both together) should not be treated as a constructive sale as long as the option is not "in the money" (measured by forward prices in the case of options longer than one year) and does not have a term longer than three years;
- The test for whether other positions (including in-the-money options and options with a term longer than three years) give rise to a constructive sale should be based on whether the value of those positions can be expected to move inversely to the value of the appreciated financial position over a significant range of prices and for a meaningful period of time; and
- Treasury should provide specific guidance in the regulations on the extent to which they will apply retroactively, and should not merely state that the regulations will apply retroactively where necessary to prevent abuse.

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<sup>1</sup> All "section" references are to the Internal Revenue Code of 1986, as amended, and to the Treasury regulations promulgated thereunder.

<sup>2</sup> Any references to the "Treasury Department" or "Treasury" as the issuer of regulations under section 1259 are meant to include the Internal Revenue Service.

## II. Background and Summary of Statute and Legislative History

Congress enacted section 1259 in 1997 to combat perceived abuses of the realization principle in connection with short sales and similar transactions.<sup>3</sup> Section 1259 effectively requires a marking to market of an appreciated financial position<sup>4</sup> if the taxpayer holding such position enters into certain so-called “constructive sale” transactions that eliminate all or substantially all of the taxpayer’s risk of loss and opportunity for gain with respect to the position.<sup>5</sup>

Prior to the enactment of section 1259, taxpayers could effectively reduce or eliminate their risk of loss and opportunity for gain with respect to property by entering into one or more financial transactions. The “short-against-the-box” transaction in particular caught the eye of Congress.<sup>6</sup> In this transaction, a taxpayer owning appreciated shares of stock, borrows identical shares and sells them. By holding two precisely offsetting positions — the pre-existing long position and the new short position — the taxpayer is insulated from economic fluctuations in the value of the stock. While the short-against-the-box is in place, the taxpayer generally leaves the original long position as collateral for the short sale obligation and withdraws the proceeds of the short sale, so that the transaction economically resembles a sale of the stock.<sup>7</sup>

Congress identified five categories of transactions to which the constructive sale rules generally apply. Taxpayers holding appreciated financial positions are treated as having made a constructive sale of the position if the taxpayer or a related person —

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<sup>3</sup> Section 1259 was added by section 1001(a) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (August 5, 1997).

<sup>4</sup> An appreciated financial position generally means any position with respect to any stock, debt instrument, or partnership interest if there would be gain if such position were sold, assigned, or otherwise terminated at its fair market value. Section 1259(b)(1).

<sup>5</sup> If a taxpayer enters into a constructive sale of an appreciated financial position, the taxpayer must recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale. Section 1259(a)(1).

<sup>6</sup> H.R. Rep. No. 148, 105th Cong., 1st Sess. 439 (June 24, 1997) (hereinafter “House Report”); S. Rep. No. 33, 105th Cong., 1st Sess. 123 (June 20, 1997) (hereinafter “Senate Report”). The short-against-the-box transaction has been around for decades. The IRS had ruled that a short-against-the-box transaction did not result in the recognition of gain until the short sale was closed. Rev. Rul. 72-478, 1972-2 C.B. 487.

<sup>7</sup> Staff of the Joint Comm. On Tax'n, *General Explanation of Tax Legislation Enacted in 1997* (December 1997) (hereinafter “Bluebook”).

- (A) enters into a short sale of the same or substantially identical property;
- (B) enters into an offsetting notional principal contract<sup>8</sup> with respect to the sale or substantially identical property;
- (C) enters into a futures or forward contract<sup>9</sup> to deliver the same or substantially identical property;
- (D) in the case of an appreciated financial position that is a short sale or a contract described in paragraphs (B) or (C) with respect to any property, acquires the same or substantially identical property; or
- (E) to the extent prescribed in regulations, enters into one or more other transactions (or acquires one or more positions) that have substantially the same effect as a transaction described in any of the preceding paragraphs.

Congress urged the Treasury Department to issue prompt guidance, including safe harbors, with respect to common transactions entered into by taxpayers.<sup>10</sup> Congress anticipated that Treasury regulations would treat as constructive sales financial transactions that, like those specified in the statute, have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for gain and income with respect to the appreciated financial position.<sup>11</sup>

Congress also anticipated that Treasury regulations, when issued, would provide specific standards for determining whether common transactions, such as collar transactions, result in constructive sales.<sup>12</sup> In a collar transaction, a taxpayer writes a call option that, if exercised, would require the taxpayer to sell the financial position underlying the option at a fixed price and acquires a put option that, if exercised, grants

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<sup>8</sup> With respect to any property, an "offsetting notional principal contact" is defined as an agreement which includes (i) a requirement to pay, or provide credit for, all or substantially all of the investment yield (including appreciation) on the property for a specified period, and (ii) a right to be reimbursed for, or receive credit for, all or substantially all of any decline in the value of the property. Section 1259(d)(2).

<sup>9</sup> A "forward contract" is defined as a contract to deliver a substantially fixed amount of property, including cash, for a substantially fixed price. Section 1259(d)(1).

<sup>10</sup> H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 514.

<sup>11</sup> Bluebook at 177. A transaction eliminating either the risk of loss or the opportunity for gain or income, but not both, is not a constructive sale. *Id.*

<sup>12</sup> *Id.*

the taxpayer the right to require the counterparty to purchase the taxpayer's financial position at a lower fixed price.<sup>13</sup>

In determining whether a collar transaction has substantially the same effect as the transactions specified in the statute, Congress anticipated that the Treasury regulations would provide specific standards that take into account various factors with respect to the appreciated financial position, including its volatility.<sup>14</sup> The legislative history says that Congress expected that under such regulations, several aspects of a collar transaction will be relevant, including the spread between the put and call strike prices, the term of the transaction, and the extent to which the taxpayer retains the right to periodic payments on the appreciated financial position.<sup>15</sup>

In determining whether an in-the-money option constitutes a constructive sale, Congress said that it expected that Treasury regulations would provide a specific standard that takes into account many of the same factors applicable with respect to collar transactions, including the yield and volatility of the stock, and the length and other terms of the option.<sup>16</sup>

Congress suggested that Treasury could rely on option prices and option pricing models in the regulations that govern collar transactions, in-the-money options, and other financial transactions.<sup>17</sup> Option pricing permits quantification of the total risk of loss and opportunity for gain with respect to an appreciated financial position, and offers an approach for quantifying the proportions of these items that the taxpayer has retained.<sup>18</sup>

Congress also suggested that Treasury regulations could establish safe harbors for common financial transactions that do not result in constructive sales.<sup>19</sup> With respect to collar transactions, a safe harbor could exempt collars that have a sufficient spread between the put and call prices, a sufficiently limited period, and other relevant terms

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<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 178.

<sup>15</sup> *Id.* Congress intended that the Treasury regulations with respect to collars would be applied prospectively, except in cases to prevent abuse. *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> The price of an option represents the payment the market requires to eliminate the risk of loss (for a put option) and to purchase the right to receive the yield or gain (for a call option). Bluebook at 178.

<sup>19</sup> *Id.*

such that regardless of the particular characteristics of the stock, the collar probably would not transfer substantially all of the risk of loss and opportunity for gain.<sup>20</sup>

### III. The Need for Guidance

Over three years have passed since the enactment of section 1259 and regulations have not yet been proposed under section 1259(c)(1)(E). Undeniably, taxpayers are coping with the lack of guidance on what constitutes a “constructive sale” by reference to the legislative history of section 1259, the published views of various commentators, and ordinary notions of when one transaction has “substantially the same effect” as another. Nevertheless, we believe that both the Internal Revenue Service and taxpayers would benefit from the issuance of regulations under section 1259.

Given the phenomenal success of the stock markets over the last two decades, many taxpayers of even relatively modest means own appreciated financial positions in the form of stock, stock options and equity mutual funds. For many (if not most) of these taxpayers, sound financial planning requires diversification or hedging<sup>21</sup> against the risk inherent in a single equity position. Yet, it is undeniable that our realization-based system of taxing capital gains deters taxpayers from selling appreciated capital assets to diversify. By enacting section 1259, Congress made it more difficult for taxpayers to diversify without realization of built-in gains, but did not go to the extreme of providing for the realization of gains in any circumstance in which the taxpayer hedges his risk of continuing to hold an appreciated financial position.

The cost of triggering gain on an appreciated financial position is in many cases enormous. If there is uncertainty as to whether a diversification transaction will trigger that gain, many taxpayers will understandably shy away from such transactions, and others will retain more risk than they otherwise would to be sure that the tax gain is not triggered. Thus, the cost of uncertainty in the application of section 1259 is that taxpayers are discouraged from undertaking prudent risk diversification or risk reduction. This is bad economic policy.

For taxpayers who do reduce their risks by, for example, collaring a stock position, the lack of guidance leaves the possibility that an Internal Revenue Service (“IRS”) agent may take the position that the collar width suggested by the taxpayer’s tax advisor as being sufficient to avoid constructive sale treatment is in fact too narrow. These disputes may well reach the IRS National Office in the form of requests for technical advice or otherwise, and some of these disputes may reach the courts. Up-front

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<sup>20</sup> *Id.*

<sup>21</sup> For purposes of this report, the term “hedging” means simply the reduction of economic risk, regardless of whether the transaction could qualify as a hedging transaction under section 1.1221-2.

guidance would minimize these disputes and ultimately would conserve government and taxpayer resources.

#### **IV. Discussion of Recommended Approaches to Regulations**

##### **A. General Considerations**

To determine the general approach the regulations should take in interpreting section 1259(c)(1)(E), it is useful to consider the purpose of that subparagraph. Had Congress not included such a provision in the definition of constructive sale, it is readily apparent that taxpayers could and would have made economically insignificant deviations from the transactions specifically listed in section 1259(c)(1)(A)-(D), retaining only a modicum of economic risk or reward in the underlying appreciated financial position, and thereby making a practical nullity of the statute. On the other hand, if a transaction does not have “substantially the same effect” as one of the enumerated constructive sales, so that the taxpayer has retained meaningful economic attributes of ownership of the underlying property, it is not appropriate in a realization system of taxing gains and losses from property to treat the taxpayer as having sold the property. The challenge, then, is to determine when a transaction has sufficiently different economic consequences from those of an actual sale that it is appropriate for the tax system to treat the two transactions differently.

This challenge consists of two parts: devising a mechanic for determining the amount of retained economic attributes and determining what amount of retained economics attributes is meaningful. We believe that the regulations should address both parts of the challenge. The legislative history, as discussed above, has provided some specific guidance regarding the mechanic. For example, for "collars, options and some other transactions, one approach that Treasury might take in issuing regulations is to rely on option prices and option pricing models."<sup>22</sup> Relatively less guidance was provided as to the amount of retained economic attributes that would be viewed as meaningful. Clearly, retaining all of the risk of loss or all of the potential for gain is meaningful. Just as clearly, eliminating all of the economic attributes with respect to a position, as in a short sale or one of the other listed transactions in section 1259(c)(1) is a constructive sale. Between these extremes, however, there is no guidance. Nevertheless, the regulations should address this issue, and must address it at least implicitly if they provide for any safe harbor. We believe that a retention of at least 5 to 10 percent of the economic attributes of a position is significant or meaningful, so that by retaining such amount, the holder of a position has not eliminated substantially all of its risk of loss and opportunity for gain and should not be viewed as having constructively sold the position.

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<sup>22</sup> Senate Report at 127.

Regardless of how the regulations approach this task, any bright lines drawn will necessarily be arbitrary. But that does not constitute a reason not to draw any lines. It is undeniable that taxpayers can be expected to plan their transactions to take advantage of any safe harbors that the regulations provide, but as long as the permitted transactions differ materially in economic effect from those listed in section 1259(c)(1)(A)-(D), safe harbors should be provided given the volume of transactions so that taxpayers will definitively know that these materially different transactions will not be treated as constructive sales.

With these general concerns in mind, we believe Treasury should divide the task of writing section 1259(c)(1)(E) regulations into two parts. First, Treasury should provide specific guidance with respect to costless equity collars and out-of-the-money stock option positions, which are by far the transactions that are most frequently used by taxpayers to hedge their investments. As part of the specific guidance, Treasury should also confirm that a single put or call option that is not in the money and that does not have a term longer than three years is not a constructive sale. Second, Treasury should provide general guidance for all other transactions, including in-the-money options, collars that are not costless, customized hedging transactions and new financial products. These are two distinct tasks, and in our view they call for different regulatory approaches.

For costless collars and out-of-the-money options, we believe what is needed is a simple bright line test, not involving complex formulas or difficult valuations, that will allow taxpayers to know up front whether entering into the collar will result in the recognition of tax gain on the collared position. Obviously, the test should not be so generous as to permit abusive transactions, but neither should it be so restrictive as to encourage taxpayers to forsake the certainty and simplicity of the safe harbor for the necessarily murkier and more complex domain of the general rule.

For other transactions, including those involving financial instruments that do not exist at the time the regulations are written, what is needed is some guidance as to how taxpayers and courts are to interpret the concept of “substantially the same effect” as one of the transactions specifically enumerated in section 1259(c)(1)(A)-(D). While we do not believe it is feasible to reduce this inquiry to a purely mechanical test, we believe the regulations can give some meaningful guidance as to (1) what is meant by the “effect” of the transactions enumerated in the statute and (2) the measure to be used in interpreting the phrase “substantially the same.” In this regard, we believe the regulations could use some (not necessarily all) of the concepts found in section 1.246-5(b) in defining substantially similar or related property (“SSRP”). The regulations could then provide examples of transactions that would be viewed as having substantially the same effect as those listed in the statute and some that would not be treated as having substantially the same effect.<sup>23</sup>

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<sup>23</sup> The regulations could deal with DECS and similar products under section 1259(c)(1)(C), relating to forward contracts, since they involve delivery of property (or cash settlement based on the property’s then value) on a future date. Section 1259(d)(1) defines a “forward contract” as “a contract to

Because of the numerous and routine nature of transactions which could arguably be subject to section 1259, the goal of the regulations should be to minimize the class of transactions that cannot meaningfully be evaluated by reference to the quantitative measures and examples in the regulations and which therefore fall into the gray area of “facts and circumstances.” If such transactions are undertaken, it is predictable that the IRS will invariably take the position that the transaction is a constructive sale while the taxpayer will invariably take the position that it is not. How might such a dispute be resolved? It is no answer to say that a court would have to consider “all the facts and circumstances” because the ultimate test that a court would have to apply — whether the transaction has “substantially the same effect” as one in which a taxpayer has transferred all of the benefits and burdens of ownership — is inherently arbitrary unless Treasury or the IRS provides guidance on how to measure “substantially the same effect.” Thus, one could not expect any consistency in the resolution of such cases, through litigation or settlement.

Because we see no reason for creating such an uncertain environment (and one that risks wasting IRS and taxpayer resources), we favor a regime that gives as much quantitative guidance as possible as to what falls within and what fall without the scope of section 1259(c)(1)(E). In that way, both taxpayers and the IRS will know in advance exactly where a transaction stands based on the objective economic facts. Such an approach would eliminate unnecessary disputes between taxpayers and the IRS, thereby conserving resources and promoting a uniform application of the law to similar fact patterns.

## **B. Collar Transactions**

### **1. General Recommendations**

By far the most common type of transaction for which guidance is needed is the “collar” transaction, which economically is equivalent to a combination of a purchase of a put option and a sale of a call option by the holder of the collared stock. A collar may be structured as a separate purchase of a put and sale of a call on the stock or as a single derivative contract. A collar on a financial asset protects the holder of the asset against the risk of loss below the put price in exchange for giving up the opportunity for gain above the call price. The asset owner retains any risk of loss and opportunity for gain within the band of the collar. Typically, collars are “costless,” which means that the amount the taxpayer would pay for the put if it were a separate transaction and the

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deliver a substantially fixed amount of property (including cash) for a substantially fixed price.” Rather than attempting to quantify “substantially,” however, we recommend that the IRS limit the application of subparagraph (C) to contracts calling for a fixed amount of property at a fixed price and address transactions requiring delivery (or cash settlement) of variable amounts of property and variable prices in the regulations under section 1259(c)(1)(E).

amount it would receive for selling the call are equal, and hence no net cash changes hands up front.

Two kinds of collars are prevalent in the marketplace. The first involves equal notional amounts of puts and calls on the underlying property where, at the outset, the puts and calls have equal values. In this case, the holder of the property has full upside and downside risk within the range of the collar but none outside the collar. We will refer to this type of collar as a Type I collar. The second involves a smaller number of calls than puts, and a lower strike price for the calls, than in a Type I collar. The ratio of puts to calls is the same as the ratio of the call strike price to the put strike price. In this type of collar, the property owner retains a fractional share of the upside above the call strike price. (The fraction is one minus the ratio of calls to puts.) We will call this a Type II collar.<sup>24</sup>

Type II collars often appear as part of a more complicated financial product. Examples of such products are DECS, ACES and Feline PRIDES.<sup>25</sup> As long as the only features of a financial product that relate to property held by the issuer consist of (or are economically equivalent to) a Type I or Type II collar on that property, we recommend that the safe harbor test we are proposing for collars be applicable.

The spread between the put price and the call price in a collar is often referred to as the “width” of the collar. These prices generally are expressed as percentages of the value of the asset at the time the collar is put in place (for example, a “95-110” collar consists of a put exercisable at 95 percent of the property's trade date value and a call exercisable at 110 percent of the property's trade date value). In a Type I costless collar on stock, because of the expectation of a rising market and the time value of money, typically the excess of the call price over 100 will be greater than the excess of 100 over the put price. In a Type II collar, it is typical for the put price to be equal to the spot price of the stock (100) and for the call price to be 120 or 125, so that the ratio of puts to calls is 6:5 or 5:4.

If a collar had a zero width (*i.e.*, if the put and call notional amounts and strike prices were the same), it would have exactly the same effect as a forward sale of the subject property for a fixed price equal to the put/call price, which is a constructive sale under section 1259(c)(1)(C). It follows that, if a collar has a very narrow width, it has substantially the same effect as such a forward sale and hence should be treated as a

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<sup>24</sup> A Type II collar could also be viewed as a Type I collar on the portion of the appreciated financial position covered by the short call options plus a put option on the excess amounts. We believe that a Type II collar should be evaluated simply as a collar.

<sup>25</sup> Salomon Smith Barney Inc. markets “DECS,” an acronym for Debt Exchangeable for Common Shares. Goldman, Sachs & Co. markets “ACES,” an acronym for Automatically Convertible Equity Securities. Merrill Lynch & Co. markets “Feline PRIDES,” a relatively recent variant of Merrill's “PRIDES,” an acronym for “Preferred Redeemable Increased Dividend Equity Securities.”

constructive sale under section 1259(c)(1)(E). The primary question that the section 1259(c)(1)(E) regulations must answer is then: “How narrow is too narrow?”

The regulations might answer this question in a very simple way: Pick a maximum width (say 20) and a maximum duration (say 5 years) and provide that any collar of the prescribed width or wider, and of a duration not longer than the maximum duration would not be a constructive sale and any narrower or longer duration collar would be a constructive sale (or would be tested under a more complicated general rule). If desired, a slightly narrower permitted width could be chosen for Type II than Type I collars because the holder of a typical Type II collar shares in the appreciation in the underlying above the call strike price. We believe that this would be a good way (but not the best way) to provide guidance on collars. Such a rule would be easy to understand and to apply, by taxpayers as well as IRS agents. Given that any line that Treasury draws in defining “substantially the same effect” is inherently arbitrary, much can be said for keeping the rule as simple as possible.

If Treasury decides to take this simple approach, we believe that 20 is a good choice for the width that is required to avoid constructive sale treatment for both Type I and Type II collars and that 5 years is a reasonable maximum duration. A 20 percentage point variance between the minimum and maximum amounts a taxpayer can realize from the collared asset during a 5-year period is in almost every circumstance a meaningful participation in the ownership aspects of the asset and hence the taxpayer is not in substantially the same position as if it had (actually or constructively) sold the asset.<sup>26</sup>

While we do not believe that the simplest possible rule would be a bad approach to this issue, we believe a slightly more sophisticated rule would be more faithful to both the legislative history of section 1259 and the most natural reading of “substantially the same effect,” without adding undue complexity. Specifically, we believe the regulations should prescribe a safe harbor for collars providing different maximum widths for different periods to maturity. Most people would agree that a 97-107 collar lasting for 6 months does not have substantially the same effect as a fixed price sale, but there would be considerably less agreement that a 3-year collar with a 10 percentage point width does not have such an effect.

It would be a relatively simple matter to set forth a collar safe harbor that would take into account the duration of the collar, in the form of a table or formula. We therefore recommend that the regulations set forth a rule that specifies the minimum width that a collar needs to avoid constructive sale treatment as follows:

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<sup>26</sup> This conclusion assumes that the appreciated financial position is not susceptible of being disaggregated. *See, e.g.*, Senate Report at 124 (“Under the regulations to be issued by the Treasury, either a taxpayer’s appreciated financial position or its offsetting transaction might in some circumstances be disaggregated on a non-*pro rata* basis for purposes of the constructive sale determination.”).

<u>Duration</u>	<u>Minimum Collar Width</u>
0-6 months	5.9%
> 6 months but ≤ 1 year	9.0%
> 1 year but ≤ 2 years	14.5%
> 2 years but ≤ 3 years	20.0%
> 3 years but ≤ 4 years	26.0%
> 4 years but ≤ 5 years	32.5%

We would see no problem with a more refined or complex table or formula that expresses collar width as a function of duration, so long as it is possible to tell unambiguously whether a collar passes or fails the test based on only its width and duration. It would seem, however, that very narrow collars, no matter how short their duration,<sup>27</sup> and that very long duration collars (say longer than five years), no matter how wide, should have to be tested under the general guidance recommended below. Again, the regulations could provide slightly more generous minimums for Type II collars, although we do not believe this is essential.<sup>28</sup>

Our recommended approach depends only on the width of the collar and its duration (and perhaps its type), not the spot or forward price of the underlying asset. Thus, this approach makes moot (for this purpose only) the question of whether the spot or forward price is the relevant reference point for testing a collar for whether it is a constructive sale. We believe this is a very useful simplification. However, to prevent abuses, the safe harbor could be limited to costless or nearly costless collars,<sup>29</sup> or

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<sup>27</sup> Collars closed within 30 days after the close of the taxable year and not reestablished within 60 days would of course be eligible for the exception to constructive sale treatment in section 1259(c)(3), no matter how narrow.

<sup>28</sup> The minimum collar widths in the table above were derived from a general analysis of the effect of duration on option pricing for various volatilities using a Black-Scholes option pricing model. The spread for a 3-year duration collar was driven by the conclusion stated above that a 20 percentage point variance between the minimum and maximum amounts a taxpayer can realize from the collared asset during a 5-year period is in almost every circumstance a meaningful participation in the ownership aspects of the asset. The spreads for shorter duration transactions were determined to provide for approximately the same amount of retained economic attributes. The spreads correspond to the retention of approximately 7 percent of the economic attributes for relatively high volatility stocks, and would represent a greater retention of such attributes for lower volatility stocks. While the choice of a safe harbor is arbitrary, we believe the safe harbor shown in the text generally represents a retention of a substantial level of economic attributes and accomplishes the purposes of section 1259. The choice of two six-month brackets followed by four 12-month brackets is, of course, arbitrary.

<sup>29</sup> In defining “costless,” it should be made clear that any separately stated fees for services provided by the counterparty, professional advisors, etc. would not be taken into account. We believe that a collar should qualify as “nearly costless” if the net amount received or paid is less than 2 percent of the value of the appreciated financial position being collared. When a collar is part of a hybrid instrument such as a DECS, the collar should be considered costless or nearly costless if it would be if entered into

alternatively to collars where both the put and call elements of the collar are out of the money (as measured by the forward price at the expiration of the collar in the case of collars with a duration of more than 3 years).<sup>30</sup> Also, the collar rule should apply only if a single collar is the taxpayer's only offset with respect to an appreciated financial position.

We recognize that the safe harbor for costless collars may in some cases be more restrictive than the general test suggested below and that taxpayers not wishing to abide by the more restrictive safe harbor are free to structure their transactions under the general test. So long as the safe harbor for collars is not unduly restrictive (*i.e.*, does not require unduly large widths to avoid constructive sale treatment), we do not believe this is a serious concern. We believe that if the collar tests are reasonable, relatively few taxpayers would be willing to forsake the certainty of the collar safe harbor for the uncertainty of the general guidance (and the risk of triggering gain on the appreciated financial position) merely to achieve a slightly closer approximation of a full short position.

If the regulation writers are not comfortable with the proposed safe harbor, then we believe either of the basic methods suggested above (single collar width or tables of widths based on duration) could be modified slightly to provide safe harbors using one width or set of widths and a rule characterizing other transactions as *per se* constructive sales using a smaller width or set of widths. In between, a transaction would be evaluated based on the general guidance described below. If this approach is taken, we again urge the regulation writers to make the safe harbors reasonable and to make the middle range small, so as to minimize the number of cases in which taxpayers and IRS agents will have to cope with the complexities and uncertainties of the general guidance.

## 2. Volatility

Both of the methods suggested above ignore completely the nature of the property being collared. In particular, a taxpayer would not take into account the "volatility" of the underlying asset in applying the safe harbor — a collar on an Internet stock would be evaluated in exactly the same way as one on a blue chip stock or a bond. This section of this report explains why a majority of the drafters and reviewers of this report believe that the volatility of the particular financial asset subject to a collar should not be taken into

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separately from the debt aspect of the hybrid. There should be a presumption that a collar imbedded in a hybrid instrument is nearly costless if the instrument is issued for its face amount and the interest rate on the instrument does not differ by more than 25 basis points from the rate the issuer would have to provide on a straight debt instrument with similar maturity, subordination, etc.

<sup>30</sup> A collar with a lower threshold substantially above the forward price for the stock on the expiration date of the collar would contain a very expensive put and a call of low value, and hence could not be costless. Conversely, a collar in a very low range would be comprised of a very valuable call and a low-value put and again could not be costless.

account in determining whether the collar transaction is a constructive sale under the safe harbor rule.

As noted above, the section 1259 legislative history suggests that the regulations should take into account the volatility of an appreciated financial position in determining whether a collar on that position will be treated as a constructive sale.<sup>31</sup> The apparent policy reason for taking volatility into account is that if an asset has a low volatility (relatively stable value), it is more likely to stay within a collar of any specified width and duration than a more volatile asset. Thus, one could say that an owner of the asset that has placed a collar on a more stable asset has retained more of the total benefits and burdens of ownership than one who has placed the same collar around a more volatile asset.

Still, it seems more consistent with the statute as written to say that a collar of a generally satisfactory width and duration ought to be treated as not having the same effect as an outright sale regardless of the characteristics of the underlying asset. Section 1259(c)(1)(E) says that a transaction is a constructive sale only if it has substantially the same effect as one of the enumerated transactions. The enumerated transactions produce a fixed return while any collar of satisfactory width and duration produces a meaningfully variable return. Thus, for example, a taxpayer who places an 80-120 collar around an asset, so that she stands to make or lose 20 percent of her investment, seems sufficiently distinguishable from another taxpayer who has sold the asset outright (or locked in the current value) whether or not the asset is highly volatile or extremely stable. As discussed above, the minimum collar width regarded as generally satisfactory might vary with the duration of the collar, because a meaningful variation for a short-term collar would not be a meaningful variation for a longer-term collar.

Most participants in this report therefore believe a strong argument can be made on statutory and policy grounds alone that volatility should play no role in determining whether a collar has “substantially the same effect” as an outright sale or forward contract at a fixed price. Nevertheless, given the legislative history and the ambiguity in the policy considerations, we do not rest our argument for ignoring volatility on those grounds alone. For the reasons set forth below, we believe that introducing asset volatility into the test for whether a constructive sale has taken place would significantly complicate the text of the regulations, the administration of the tax law and the rendering of tax advice for no appreciable benefit to either taxpayers or the IRS.

One might describe the economics of ownership of a non-income-producing financial asset as consisting of the value of the asset plus the right to appreciation in the asset (the benefit of ownership) minus the risk of depreciation in the asset (the burden of ownership).<sup>32</sup> The upside could be represented by an at-the-money call right and the

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<sup>31</sup> Bluebook at 178.

<sup>32</sup> The analysis is somewhat more complicated for a dividend-paying stock or other income-

downside as an at-the-money put obligation.<sup>33</sup> That is, the owner of property is “long” a call right and “short” a put right. The strike price at which the put and call will have equal value is the forward price of the property, which in theory is the spot price of the property plus an adjustment for market interest rates.<sup>34</sup>

Following this concept, one might then evaluate whether a collar gives rise to a constructive sale by comparing the values of the put and call options comprising the collar to the values of the put and call options that together comprise complete ownership of the underlying asset. The regulations might then set forth a rule that says, for example, that a collar will be treated as a constructive sale if the sum of the values of the put and the call in the collar (both taken as positive numbers for this purpose) is greater than a specified percentage (in the range of 90 to 95 percent) of the sums of the values of the at-the-money put and the at-the-money call. Everything else being equal, such a rule would require wider collars for more volatile assets, and would permit narrower collars for less volatile assets, than a rule based simply on collar width and duration.

Of course, such a rule depends on the ability to determine a value for options. The section 1259(c)(1)(E) regulations could approach this problem in one of two ways. The regulations could either set forth a precise mathematical formula for valuing the options comprising the collar or they could leave to taxpayers the burden of proving the value of those options, based on whatever factors and formula the taxpayer and the counterparty to the collar used in structuring the collar. While we would strongly prefer the second approach to the first, we believe that the complexity of either approach would far outweigh any actual or perceived benefits of fairness to the tax system over the simple rule suggested above.<sup>35</sup>

#### a) Mathematical Formulas

Option pricing is no simple matter. While various formulas have been developed to price options, no one formula has gained universal acceptance even for a single type of option. Moreover, even the simplest of the formulas is quite complex, requiring the use

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producing asset.

<sup>33</sup> For present purposes, it is not necessary to distinguish between spot and forward prices in determining whether an option is “at-the-money,” but it generally is the forward price that is relevant (at least in the case of European style options, where the long party cannot exercise immediately to capture the spot/forward differential).

<sup>34</sup> See John C. Hull, *Options, Futures, and Other Derivatives*, § 7.6 (3d ed. 1997) (hereinafter “Hull”).

<sup>35</sup> Nevertheless, such an approach might be adopted as a more general means of evaluating whether a transaction is a constructive sale under the general guidance (as opposed to the safe harbor) to be provided by the regulations, as discussed below.

of mathematical concepts far beyond the realm of experience of most taxpayers and IRS agents. Based on other commentary on section 1259,<sup>36</sup> it appears that even the experts disagree as to the proper application of such models in this context.

The basic option pricing model for European-style stock options is the Black-Scholes model. The formula<sup>37</sup> for determining the cost (C) of an option on stock is as follows:

$$C = SN(d_1) - Ee^{-rT}N(d_2)$$

where

$$d_1 = \frac{\ln(S/E) + (r + \sigma^2/2)T}{\sigma\sqrt{T}}$$

$$d_2 = d_1 - \sigma\sqrt{T}$$

with

S = share price

E = exercise price of option

$\sigma$  = standard deviation (i.e., the volatility measure)

r = risk-free interest rate

e = exponential constant (= approx. 2.718)

T = time to maturity of the option

N(\*) = cumulative normal density function

ln = natural logarithm

This formula applies only to European-style options on non-dividend paying stocks and assumes constant interest rates and constant volatility over the life of the option. In the real world, where these assumptions do not hold in practice, much more complex versions of the options pricing model are used.

If the regulations were to specify a formula that would be used for tax purposes, even a simplified formula could not ignore all of these complexities. For example, a formula that did not take into account dividends on the underlying stock or the fact that most options are American-style would not be of much practical use.

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<sup>36</sup> Compare Memorandum from the Ad Hoc Coalition on Intermarket Coordination to Lon Smith, Assistant Chief Counsel, Financial Institutions & Products (October 5, 1998) (hereinafter the "Options Exchanges Memorandum"), reprinted in 98 TNT 205-30, with Letter from Anthony J. Cetta, Chairman, Comm. On Fed. Tax'n, SIA, to Lon B. Smith, Assistant Chief Counsel, Financial Institutions & Products (Nov. 10, 1998) (hereinafter "SIA Letter"), reprinted in 98 TNT 238-20.

<sup>37</sup> See Richard M. Bookstaber, *Option Pricing and Investment Strategies* 465 (3d ed. 1991).

Even assuming that it would be possible to derive a formula that would be simple enough to write into the regulations, yet flexible enough to be useful in most situations likely to arise in practice, that formula would not produce the desired result of allowing a purely objective determination of whether a transaction constitutes a constructive sale. Any option pricing formula, including the basic Black-Scholes formula, will require at least five inputs: (i) the spot price of the underlying stock; (ii) the strike price of the option; (iii) the time to maturity of the option; (iv) an interest rate; and (v) the expected volatility of the underlying stock.<sup>38</sup> Interest rates and expected volatility are both subjective. While interest rates could be made objective by using a risk-free rate (such as an applicable Federal rate), doing so would lose some of the accuracy of the formula.<sup>39</sup>

Expected volatility is highly subjective. While in many cases, an objective measure of expected volatility can be derived from past volatility or from observed prices of options actually traded in the marketplace,<sup>40</sup> this is not always possible in the case of relatively recent issues and, in any event, any objective formula is certain to result in prices that differ (in some cases significantly) from actual market prices. Moreover, there is considerable flexibility in deciding how far to go back in using past trading data to project future volatility. Well-advised taxpayers may be able to exploit these ambiguities to avoid a constructive sale.

The marketplace recognizes the limitations of mathematical models. Consider the “options calculator” located on the web site of the Chicago Board Options Exchange (“CBOE”).<sup>41</sup> The CBOE calculator uses the Cox-Ross-Rubinstein binomial approximation of the Black-Scholes option pricing model. While acknowledging that this and other approximations of the Black-Scholes model are the most popular models for pricing options, the CBOE cautions users that there are other models available that consider different factors and that no one model can be entirely accurate.<sup>42</sup> With respect to volatility, the CBOE cautions users that:

Volatility has a significant influence on the price of an option contract. Small variations in these estimates can result in significantly different prices. It is important to understand that during any trading day the consensus among traders and investors on an estimate of future market volatility is dynamic and can change

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<sup>38</sup> *Id.* at 46.

<sup>39</sup> While some versions of the Black-Scholes model incorporate a risk free interest rate, interest rates vary in the market place based on a number of factors, including the credit worthiness of the parties in question.

<sup>40</sup> See Hull at §§ 11.3 & 11.10.

<sup>41</sup> The address is “[www.cboe.com/tools/optcalcu.htm](http://www.cboe.com/tools/optcalcu.htm)” (hereinafter “CBOE Website”).

<sup>42</sup> CBOE Website (information).

frequently and abruptly. Therefore, do not expect prices you generate with this calculator to resemble prices found in the market place.<sup>43</sup>

To summarize, we strongly object to putting a mathematical formula for option valuation into the regulations because such a formula would be complex and inaccurate and would fail to provide the hoped-for benefit of objectivity.<sup>44</sup>

## b) Taxpayer Valuations

As noted above, the regulations could leave to taxpayers the burden of proving the value of the options comprising the collar, based on whatever factors and formula the taxpayer and the counterparty used in structuring the collar. The regulations could thus adopt a rule, relatively simple to state, that a collar would be treated as a constructive sale if the sum of the absolute values of the purchased put and the sold call comprising the collar exceeded a specified percentage (in the range of 90 to 95 percent) of the sum of the absolute values of the put and call with the same expiration date and other terms but with a strike price in each case equal to the forward price of the property in question.<sup>45</sup> This formulation would avoid some of the problems of the mathematical formula approach: it would not complicate the statement of the regulation with difficult mathematical concepts and it would not require a separate valuation for tax purposes that could differ significantly from the actual value of the options in question. In exchange, however, this approach would produce even greater uncertainty than the formula approach. Uncertainty would arise not only from the subjectivity of the inputs into the model (as above) but also in the choice of the model.<sup>46</sup>

This uncertainty would place a great burden on taxpayers as well as on the IRS. As a planning matter, it would be difficult for taxpayers and their advisors to know what size collar would be acceptable for tax purposes without consulting an investment bank.

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<sup>43</sup> CBOE Website (important information, volatility).

<sup>44</sup> Other commentators have raised additional concerns with respect to the use of mathematical models. *See, e.g.,* Tax Section, NYSBA, *Comments on "Short-Against-The-Box" Proposal* (March 1, 1996) (discussing several limitations of using option prices to calculate the retained risk of loss and opportunity for gain).

<sup>45</sup> Options Exchanges Memorandum at 11-12.

<sup>46</sup> The regulations might attempt to reduce the uncertainty by specifying certain models that would be acceptable for tax purposes. The regulations could provide, for example, that a taxpayer may use a variant of the Black-Scholes option pricing model or an accepted version of the binomial model. *Cf. Rev. Proc. 98-34, 1998-1 C.B. 983* (permitting the use of the Black-Scholes option pricing model to value compensatory options for transfer tax purposes). If permissive and not unduly restrictive, this might help avoid disputes in some situations, but would provide little help to agents in evaluating situations not covered by the general guidance.

The minimum width of the collar would change daily. Different counterparties would give different quotes, leading conservative taxpayers to pick the wider collars for safety and more aggressive taxpayers to pick the narrower collars.

Given the high stakes of whether a constructive sale has taken place, taxpayers would have to maintain detailed contemporaneous records as to how the option valuations were obtained. For virtually all taxpayers, these could only be provided by the investment bank or other counterparty to the collar. Full written analyses would not come cheap, and it is foreseeable that many investment banks would be unwilling to produce their actual pricing methodology, regarding it as proprietary. (It would also force the investment banks to reveal the implicit fees built into the option pricing, which might also be viewed as objectionable.)

For the IRS, the prospect of auditing option pricing might be daunting. The IRS already faces the burden of valuing options and other derivatives under the mark-to-market rules of section 475, and in certain circumstances must test the taxpayer's valuations of the "mini-options" that comprise an interest rate cap or floor under section 1.446-3(f)(2)(iv); but, we believe that the expansion of this burden to the world of custom-designed collars, entered into primarily by individuals, would significantly increase that burden.

If this approach were adopted, disputes and recordkeeping burdens could be minimized by providing in the regulations that any valuation methodology actually employed by the taxpayer and the counterparty to its collar would be acceptable for tax purposes. Under such a system, a taxpayer could obtain a certification from its counterparty that, based on the actual pricing methodology used by the investment bank, the collar met the standard of the regulations for avoiding constructive sale treatment. The taxpayer would not necessarily have to obtain the actual pricing information. The IRS could then perform limited spot checks to insure that the methodology underlying the certification was in fact the one used in pricing the actual transaction.

### c) Recommendation with Respect to Volatility

To summarize, both the formulary approach and the taxpayer valuation approach to incorporating volatility into the constructive sale safe harbor are fraught with problems. The former would be complex to state and apply and would not produce the desired certainty. The latter would be simpler to state but would in effect impose burdensome recordkeeping requirements on parties entering into collar transactions and would produce even more uncertainty.

In our view, these problems would be unfortunate but perhaps tolerable if expressly mandated by statute. In the case of section 1259, the statute is silent on the question of volatility and the legislative history merely notes that Congress "anticipated" that the regulations would take volatility into account. We believe that permits Treasury to conclude, in light of the substantial problems that volatility would introduce into the

statement and administration of the law under section 1259 and the very limited (if any) policy improvement that taking volatility into account would provide, that the regulations should ignore volatility entirely, at least with respect to a safe harbor for collars.

If this recommendation is not accepted, then it is our unanimous recommendation that the regulations provide two parallel tests for collars, one ignoring volatility and the other based on option pricing (as determined under any reasonable approach used by the taxpayer and its collar counterparty). A collar then would not give rise to a constructive sale if it met either of the two standards. The two standards should be designed to produce essentially the same result for stocks (or stock indices) of average volatility, so that in a meaningful percentage of the cases that arise, taxpayers could use the simpler (non-volatility-based) rule without having to use a substantially larger collar than would be permitted under the more complex rule. More specifically, if such a parallel test were adopted, we recommend the simple duration and width-based table suggested earlier in this report as a safe harbor, with a volatility based test to allow taxpayers who enter into collars on very low volatility assets to use narrower collars without triggering constructive sale treatment.

### **C. Options**

Section 1259 was not intended to apply to a taxpayer who reduces (or even eliminates) risk of loss on an appreciated financial position and retains all of the upside potential, or vice versa. A taxpayer seeking to avoid the constructive sale rules, however, might use a deep-in-the-money option to achieve the substantial equivalent of a forward sale of the property for a fixed price. For example, if an appreciated financial position were worth \$100, the taxpayer might sell a 3-month call option to acquire the property at a strike price of \$10.<sup>47</sup> Such an option would almost certainly be exercised (so that the taxpayer effectively retains none of the economic attributes of the property) and would have a market value very close to \$90. Somewhat less likely would be a purchase of an option to put the property for say \$200, which would have a value of close to \$100 if the term of the option were short enough.

To protect simple option transactions without permitting abuses, we recommend that the regulations provide that a taxpayer who purchases a put option or sells a call option on an appreciated financial position (but not both) should not be treated as having engaged in a constructive sale as long as the option is not “in the money” and does not have a term longer than three years. While this is not the unanimous view, we believe that whether an option is “in the money” should be determined by reference to the forward price of the property on the expiration date, not the spot price on the date the option is purchased. To simplify application of the rule, however, we believe that taxpayers should be permitted to use the spot price rather than the forward price for

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<sup>47</sup> All options used in the illustrations are assumed for simplicity to be European style options.

options with a term of three years or less. “In the money” options would not necessarily give rise to a constructive sale, but would be tested under the general guidance described below.

We recognize that the legislative history to section 1259 suggests that an option would not give rise to a constructive sale unless it is in the money as measured by the current market price of the property.<sup>48</sup> In our view, this statement ignores the effect of the time value of money in option pricing and valuation.<sup>49</sup> In light of the broad language of section 1259(c)(1)(E), we believe that the regulations are not constrained by this aspect of the legislative history, although we recommend that a rule based on forward prices apply only prospectively because taxpayers may have relied on the legislative history for guidance prior to the issuance of regulations and because this aspect of the regulations would likely be viewed as controversial.

#### **D. General Guidance**

##### **1. Recommended Approach**

The effect of a short sale against the box with respect to an appreciated financial position is that, even though the taxpayer remains the legal owner of the position, he is no longer subject to any economic effect from changes in the value of the position. The same is true for a forward contract to sell a fixed amount of the position at a fixed price, as well as a notional principal contract under which the taxpayer is obligated to make a nonperiodic payment equal to the value of the position on a future date. In other words, the *effect* of the short position is that it perfectly offsets changes in the value of the appreciated financial position.

Accordingly, a position or combination of positions has *substantially the same effect* as a short sale if it substantially offsets changes in the value of the appreciated financial position. The questions, then, are how to measure the degree of offset and how to determine whether the degree of offset is “substantially the same” as a perfect offset.

We recommend that the regulations include a general rule that a position or combination of positions should be treated as having substantially the same effect as a perfect offset of an appreciated financial position (a “nearly perfect offset”) if it is reasonably expected that there will be a very strong inverse correlation between the value

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<sup>48</sup> Bluebook at 178.

<sup>49</sup> The forward price of a stock issue exceeds the spot price by a factor that depends primarily on interest rates and the dividend rate (if any) on the stock, and the time interval to the point at which the forward price is being measured. Thus, for long-term European-style options, using spot prices will systematically overstate the extent to which put options are in the money and understate the extent to which call options are in the money.

of the appreciated financial position (or some fraction or multiple thereof) and the value of the offsetting position(s). This standard is based on the concept of “diminished risk of loss” in section 1.246-5(b)(2), a concept that is well-established and familiar to taxpayers, but we believe that a stronger inverse correlation should be required for a transaction to be a constructive sale than for it to be considered to have tolled the taxpayer’s holding period for stock under section 246(c)(4). This relatively simple general rule, if clarified by a few rules of application and examples, should provide the necessary guidance to taxpayers and agents as to what constitutes a constructive sale.

The first needed clarification we recommend relates to the strength of the inverse correlation required to effect a constructive sale. To be considered a strong inverse correlation, a correlation must remain constant or nearly constant over a significant range of price changes and for a meaningful period of time.<sup>50</sup> Necessarily, the touchstone here should be the three transactions enumerated by Congress in section 1259(c)(1)(A) through (C). All three of these transactions (short sale, offsetting notional principal contract, and forward contract) function as a complete hedge of all or part of the appreciated financial position when entered into (that is, they have a negative correlation) and, equally as important, all three of these transactions are reasonably expected to maintain their effectiveness as hedges as the value of the appreciated financial position changes (that is, they do not need to be constantly adjusted).<sup>51</sup> These two characteristics - - inverse correlation, constant effectiveness — define what Congress considered to be constructive sales. They therefore should serve as the foundation of the general test.

Thus, it is not enough that a position when acquired have some negative correlation to the value of a fraction of the appreciated financial position, for that would describe any option on the position, no matter how short in duration and no matter how far out of the money.<sup>52</sup> We strongly believe that the general rule should not be written in such a way as to cast doubt on every option position that does not meet the safe harbor suggested above.

We recommend that the regulations quantify the concepts of “nearly constant,” “significant range of prices,” and “meaningful period of time” either by per se rules or by examples. In either case, we believe that “nearly constant” should mean something like constant plus or minus 10 percent, “significant range of prices” should mean something

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<sup>50</sup> The degree of correlation resulting in a constructive sale should be related to whether substantially all of the economic attributes of the appreciated financial position have been transferred by the taxpayer. That is, the correlation resulting in a constructive sale should correspond to eliminating substantially all of the economic attributes (for example, 90 to 95 percent of the economic attributes) of owning the position.

<sup>51</sup> A hedge that needs to be adjusted continually to maintain its effectiveness is sometimes referred to as a “dynamic hedge.”

<sup>52</sup> The ratio of the change in value of an option to the change in value of the underlying stock is referred to as the option “delta.” *See* Hull at § 9.6.

like the spot price plus or minus 10 percent, and “meaningful period of time” should mean something like the lesser of six months or the shortest of the durations of all the offsetting positions held by the taxpayer. Under this standard, short-term option positions would tend not to be considered constructive sales unless very deep in the money, while long-term options would tend to meet the definition unless very far out of the money.

Second, we recommend that the regulations make it clear that, for purposes of determining whether a constructive sale has occurred, all positions that relate to an appreciated financial position should be taken into account and any positions that do not relate to the appreciated financial position should be ignored (or deemed to maintain a constant value). Thus, a taxpayer should not be permitted to avoid the constructive sale rules by breaking up offsetting positions into two or more pieces. Similarly, a taxpayer should not be able to avoid a constructive sale by combining one or more positions that would give rise to a constructive sale with one or more extraneous positions.<sup>53</sup> For example, if a taxpayer T owns appreciated stock in Company A and enters into an equity swap under which T receives at the end of two years the excess of the value of a specified number of shares of Company B stock over the value of a certain number of shares of Company A stock, or pays the excess of the value of the Company A stock over the value of Company B stock, that must be treated as a constructive sale of the Company A stock.

## 2. Alternate Approach

A possible objection to the approach recommended above is that it is complex and requires information that may not be readily accessible to the taxpayer. This may not be a serious problem in practice because the counterparties to these types of transactions may generally be investment banks that can provide the taxpayer with whatever information is required by the regulations. Moreover, taxpayers in most cases can avoid the complexity of the general guidance by undertaking a transaction within a safe harbor.

Nevertheless, if these or other concerns with the general rule are viewed as significant, we suggest an alternative and somewhat simpler approach to the definition of constructive sale, based on the notion that the economics of owning a non-income producing financial asset can be described as the current value of the asset plus benefits of ownership (represented by an at-the-money call) minus burdens of ownership (represented by a short at-the-money put).<sup>54</sup> Under this alternative approach, a financial instrument (or a combination of two or more such instruments) would be treated as a constructive sale of an appreciated financial position if, during any time period ending on or before the last date on which the value of one or more of the financial instruments is affected by the value of the appreciated financial position, the value of the taxpayer’s net

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<sup>53</sup> Cf. section 1.246-5(c)(7) (ignore netting of payment in notional principal contracts).

<sup>54</sup> The definition, as noted above, is somewhat more complicated for a dividend-paying stock or other income-producing asset.

retained economic interest in the benefits of the property was less than 10 to 20 percent of the total benefits of ownership of the property (as measured by the value of an at-the-money call expiring on that date) and the value of the net retained interest in the burdens of ownership was also less than 10 to 20 percent of the total burdens of ownership (similarly measured). Thus, a constructive sale would not arise if the taxpayer retained a net economic interest of at least 10 to 20 percent<sup>55</sup> either in the benefits, or in the burdens, of ownership of the property.

To illustrate how this alternative rule would work in a relatively simple case, consider a taxpayer who enters into a collar transaction that for some reason does not qualify for a safe harbor. Suppose for example that a taxpayer owns XYZ stock with a current value of \$100 and enters into a two-year costless collar comprised of a put with a strike price of \$107 and a short call with a strike price of \$119. (The width of 12 is narrower than the suggested minimum width of 14.5 for two-year collars.) Suppose further that the forward price of XYZ stock after two years is \$113 and that the value of two-year put and call options at this strike price would each be \$30. Then the collar would be a constructive sale if the value of the two options comprising the collar would each be \$27.00 or more (90 percent of the value of each at-the-money option).

To apply this rule to in-the-money options, it would be necessary to recast the option as a combination of an out-of-the-money option of the opposite type and a long or short position in the property (and in some cases a loan), using so-called “put-call parity.”<sup>56</sup> Thus, for example, a sale of a deep in-the-money call option is equivalent to a sale of the property plus the sale of a far out-of-the money put option on the property. (The portion of the sale price represented by the option strike price is loaned to the buyer for the term of the option.) Similarly, the purchaser of a deep-in-the-money put option is in the same position as if he had sold the property, purchased a far-out-of-the-money call, and made a loan of the net amount to the seller of the put.<sup>57</sup> If the put (in the first case) or call (in the second) is so far out of the money that it is worth less than 10 to 20 percent of the value of the corresponding at-the-money option, then the taxpayer may be in substantially the same position as if he had sold the property outright.

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<sup>55</sup> The actual values should be chosen to correspond to some level of retained economic attributes equivalent to 5 to 10 percent of the total economic attributes.

<sup>56</sup> See Hull at § 7.6.

<sup>57</sup> The value of the retained option position can be derived in each case from the proceeds or cost of the actual option bought or sold, the option strike price, the spot value of the property and an assumed interest rate. For example, if a taxpayer who owns non-income producing property worth \$100 sells for \$30 a 6-month call on the property with a strike price of \$80, and if the relevant interest rate is 8 percent, the present value of the \$80 strike price is approximately \$77, so the value of the implicit put right is \$7 (\$30 + \$77 - \$100). If that taxpayer were to buy for \$35 a 6-month put on that property with a strike price of \$120, the strike price has a present value of about \$115 and the value of the implicit call would be \$20 (\$100 + \$35 - \$115).

A taxpayer who sells an in-the-money call on property has retained none of the benefits of ownership and has retained the burdens of ownership only to the extent value of the property falls below the call strike price. Similarly, the buyer of an in-the-money put has retained none of the burdens of ownership and has the benefit of ownership represented by the possibility that the property will exceed the put strike price. Thus, under the alternative test described above, the sale of an in-the-money call or the purchase of an in-the-money put would be considered as substantially equivalent to a forward contract (and hence a constructive sale) if the value of the corresponding out-of-the-money short put or long call is less than 10 to 20 percent of the value of an option on the property with the same expiration date but with a strike price equal to the forward price of the property on that date.<sup>58</sup> For purposes of computing the value of the implicit option, the discount rate used for any future cash flows might be the applicable Federal rate.

As in the discussion of options above, we believe that under the alternative approach the regulations should provide that forward price is the relevant measure for determining whether an option is in the money. Thus, even a short call that appears to be “at-the-money” when measured by reference to the spot price could be considered a constructive sale under the test we have proposed. For example, if T owns stock worth \$100 and T sells for \$75 a right to call the stock in 20 years for \$100, the sum of the price received for the call (\$75) and the present value of the call price (approximately \$31) exceeds the spot price of the property (\$100) by \$6, which is taken to be the value of the retained out-of-the-money put. If this value is less than 10 to 20 percent of the value of an option on the property with the same expiration date but with a strike price equal to the forward price of the property on that date (*i.e.*, the at-the-forward-price 20-year put is worth more than \$60 or \$30), the transaction would be a constructive sale. In other words, the apparent downside risk to T that the stock in 20 years will be worth less than its current price under these facts may not be a very significant economic risk.

### ***E. Effective Dates***

The legislative history to section 1259 states that any regulations under section 1259(c)(1)(E) as to when a collar has substantially the same effect as a forward sale are to be applied prospectively “except in cases to prevent abuse.” In implementing this principle, we see Treasury as having essentially two choices. First, the regulations could simply state that the regulations will apply prospectively except in abuse cases, and then leave to the courts to determine what cases are abuse cases. Second, the regulations could define a subset of the transactions that would be considered constructive sales prospectively and treat this subset as constructive sales retroactively. As in the prospective guidance, the retroactive guidance could be either black and white or could provide safe harbors and *per se* abuses, with a facts-and-circumstances gray zone in between.

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<sup>58</sup> Such a call would also be considered “deep in the money” for purposes of section 1092(c)(4)(B)(iii).

In the strongest possible terms, we urge Treasury not to adopt the first approach. That would be an invitation to IRS agents to challenge every transaction undertaken between the effective date of the statute and the publication of the regulations that did not meet the standards of the regulations. This would both waste IRS resources and be unfair to taxpayers. The problem would be especially acute if the regulations adopt relatively strict rules going forward.

Instead, we recommend that either the regulations be applied only prospectively or that the regulations apply retroactively only to a very limited and specifically defined class of transactions deemed abusive. We recognize that the latter approach could significantly increase the burden on the regulation writers. However, we believe that this burden is worthwhile and in any event far less than the burden that will be placed on taxpayers, IRS agents and the courts by challenges to existing transaction that are likely to arise under the first approach. Moreover, this burden can be lessened by adopting relatively simple rules for what will and will not be considered abusive transactions for this purpose. For example, if the regulations adopt our suggestion of providing objective, safe harbors for costless collars on a going forward basis, essentially the same tests could be adopted retroactively with more generous numerical limits.<sup>59</sup> Whatever the particular standard chosen, it is vitally important that the regulations give taxpayers and agents as much guidance as possible so as to minimize the ranges of potential disputes, thereby reducing the cost to the fisc and to taxpayers.

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<sup>59</sup> Alternatively, as discussed above in paragraph IV.B., the regulations could simply provide that any collar with a duration no greater than 5 years and a width of at least 20 percent would not be considered an abusive transaction.