INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
July 21, 2000

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CASE MIS No.: TAM-101737-00/CC:FIP:B3

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =
Bank =

Number1 =
Number2 =
Number3 =

Percent1 =
Percent2 =

Value1 =
Value2 =
Value3 =
Value4 =
Value5 =
Value6 =
Value7 =
Value8 =
Value9 =

Year1 =
Year2 =

Date1 =
Date2 =
Date3 =
Date4 =

ISSUE:

For purposes of the special effective date rule in § 1.1092(d)-2(b)(2) of the Income Tax Regulations (which can cause certain transactions to be straddles through the retroactive application of the regulations implementing § 1092(d)(3)(B)(i)(II) of the Internal Revenue Code), is the phrase "an option on the stock index" limited to options on stock indexes on which there are regulated futures contracts?

CONCLUSION:

Yes. The phrase "an option on the stock index" in § 1.1092(d)-2(b)(2) applies only to stock indexes on which there are regulated futures contracts (and, in particular, does not apply to private "custom" stock indexes).

FACTS:

Taxpayer is a large mutual insurance company.

In Year1, Taxpayer owned a diversified portfolio of common stocks and investments in mutual funds.

Taxpayer entered into a "costless collar" arrangement with Bank to hedge certain stocks and mutual funds in its portfolio (the "Hedged Portfolio") against a possible decline in the stock market. On Date1, Taxpayer purchased from Bank a cash-settled put option (the "Put Option") on a custom stock index (the “Custom Index”) and sold to Bank a cash-settled call option (the "Call Option") on the same custom stock index.[1] The expiration date of each option was Date2. The strike price of the Put Option for one unit of the Custom Index was Value1. The strike price of the Call Option for one unit was Value2. The Put Option and the Call Option were both for Number3 units of the Custom Index, so that the net strike price of the Put Option was Value3 and the net strike price of the Call Option was Value4. When the options expired on Date2, Taxpayer had suffered a loss of Value5 on the Call Option. Taxpayer claimed that loss of Value5 on its Year2 federal income tax return.

The Hedged Portfolio consisted of Number1 stocks with a value on Date1 of approximately Value6, Number2 stocks with a

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[1] The Custom Index had features similar to exchange-traded stock indexes, such as adjustments for stock splits.

value of approximately Value7, and investments in mutual funds and an account with a value of approximately Value8. Thus, the total value of the Hedged Portfolio on Date1 was approximately Value9.

The Revenue Agent took the position that the Hedged Portfolio and the Call Option constituted a straddle to which § 1092 applied to defer the loss of Value5 on the Call Option. The Revenue Agent did not assert that the transaction was part of a tax shelter or was otherwise an abusive transaction.

A presubmission conference was held on Date3. Taxpayer subsequently submitted a memorandum arguing that the phrase "an option on the stock index" in § 1.1092(d)-2(b)(2) is limited to options on stock indexes on which there are regulated futures contracts, and therefore that § 1092(d)(3)(B)(i)(II) does not apply. The Revenue Agent was not persuaded by Taxpayer's memorandum and proceeded with the request for technical assistance.

An adverse conference was held on Date4. Taxpayer submitted additional materials within the 21-day period.

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 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.]

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).

ANALYSIS:

The issue is the meaning of the phrase “an option on the stock index” in the larger phrase

> 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)

in § 1.1092(d)-2(b)(2)(ii). If Congress had used the phrase “an option on such a stock index,” the phrase would obviously be limited to stock indexes on which there are regulated futures contracts. On the other hand, if Congress had used the phrase “an option on a stock index,” the phrase would obviously not be limited to such stock indexes.

Taxpayer argues that the definite article “the” in the phrase “an option on the stock index” requires that the phrase “the stock index” refer back to the stock index in the antecedent phrase “a stock index regulated futures contract.” Taxpayer argues further that the stock index in the phrase “the stock index” must have all of the attributes implied by the antecedent phrase and that the antecedent phrase implies that the stock index has regulated futures contracts traded on it.

We agree that Taxpayer’s interpretation is the most natural interpretation in the sense that readers are more likely than not to read the phrase that way. However, we are not convinced that the antecedent phrase necessarily implies that the stock index has regulated futures contracts traded on it. Thus, the larger phrase could be read to mean

> a short position in any of the following instruments with respect to a stock index: a regulated futures contract on the stock index, an option on such a regulated futures contract, or an option on the stock index

if that were necessary to achieve manifest congressional intent.

We are sympathetic to the propositions that retroactive rules should be interpreted narrowly and that ambiguities should be resolved against retroactivity. However, the fact that Congress explicitly directed that the regulations be retroactive for certain transactions imposes upon us an obligation to attempt to determine whether this case is one for which Congress intended retroactive application.

It is not apparent that Congress directed retroactive application of the regulations because it considered the specified transactions to be especially abusive.[2] Nor has it been suggested that this transaction is abusive.

Based on our conclusion that Taxpayer's interpretation of the phrase is the most natural, the fact that it interprets a retroactive rule narrowly, and the absence of evidence that Congress directed retroactive treatment because it considered the transactions to be abusive, we resolve the issue in Taxpayer's favor.

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.

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[2] Taxpayer has offered the plausible theory that Congress originally conceived the retroactive rule for regulated futures contracts on stock indexes and then extended the rule to options on such regulated futures contracts and options on stock indexes with regulated futures contracts in order to achieve consistent tax treatment for similar instruments.