

MEMO# 13160

February 14, 2001

IRS ISSUES PROPOSED REGULATIONS ON INTEREST AND CARRYING CHARGES FOR TAX STRADDLES

[13160] February 14, 2001 TO: TAX COMMITTEE No. 6-01 RE: IRS ISSUES PROPOSED REGULATIONS ON INTEREST AND CARRYING CHARGES FOR TAX STRADDLES In the attached regulations (Prop. Treas. Reg. 1.263(g)-1 through 5; 1.1092(d)-1(d)), the Internal Revenue Service ("IRS") addresses generally the capitalization of interest and carrying charges on tax straddles under section 263(g) and the circumstances under which an issuer's obligation under a debt instrument can be a position in a tax straddle. The regulations would apply to interest and carrying charges properly allocable to personal property that are paid, incurred or accrued after the regulations are issued in final form for tax straddles established on or after January 17, 2001. Background Section 1092 defines a tax straddle as offsetting positions with respect to "actively traded" personal property. Positions are offsetting when there is a substantial diminution of risk of loss from holding one position by reason of holding another position. Among other adverse tax consequences of holding a tax straddle, realized losses on one position in a straddle must be deferred to the extent there is unrealized gain in any other position in the straddle. Under section 263(g), interest and carrying charges that are properly allocable to personal property that is part of a straddle are not currently deductible. Rather, these amounts must be capitalized into the basis of the property. By requiring capitalization, section 263(g) is intended to prevent timing and character mismatches for straddle-related income inclusions and expense deductions. The proposed regulations address four issues under section 263(g): (1) the definition of "personal property"; (2) the type of payments that are subject to capitalization; (3) rules for allocating amounts to personal property that is part of a straddle; and (4) the circumstances under which an issuer's obligation under a debt instrument can be a position in a tax straddle.

2Definition of Personal Property Section 263(g)(1) requires capitalization of interest and carrying charges that are properly allocable to "personal property" that is part of a tax straddle. For purposes of section 263(g), the proposed regulations define "personal property" as a property right, whether or not actively traded, other than a right in real property. Personal property does not, however, include a position that imposes obligations but does not confer substantial rights on the taxpayer. This definition of personal property is broader than that provided under section 1092(d)(1), which defines personal property as property of a type that is "actively traded." The preamble to the proposed regulations explains that the broader definition of personal property is supported by the statutory language of section 263(g) and necessary to apply comparable capitalization rules to economically similar transactions.

Payments Subject to Capitalization Section 263(g)(1) provides for the capitalization of interest and carrying charges. For this purpose, interest and carrying charges are defined as "interest on indebtedness incurred or

continued to purchase or carry the personal property” and “all other amounts (including charges to insure, store or transport the personal property) paid or incurred to carry the personal property,” reduced by certain allowable income offsets. Accordingly, interest and carrying charges subject to capitalization under the proposed regulations include: (1) otherwise deductible payments or accruals (including interest and original issue discount) on indebtedness or other financing issued or continued to purchase or carry personal property that is part of a straddle; (2) otherwise deductible fees or expenses paid or incurred in connection with the taxpayer’s acquiring or holding personal property that is part of a straddle, including but not limited to, fees or expenses incurred to purchase, insure, store, maintain or transport the personal property; and (3) otherwise deductible payments or accruals on financial instruments that are part of a straddle or that carry part of a straddle.

Allocation Rules The proposed regulations provide three specific allocation rules for certain transactions. First, for transactions where a taxpayer has borrowed money to purchase personal property that is part of a straddle (so-called “cash and carry” transactions), the proposed regulations allocate any resulting interest expense to the capital account of the personal property. This allocation rule prevents a taxpayer from taking ordinary interest expense deductions in advance of realizing a predictable (and typically offsetting) amount of capital gains from the forward sale of the personal property. Second, interest expense is allocated to the capital account of personal property used as collateral for the borrowing. Third, interest expense is allocated to the capital account of personal property when payments on the indebtedness are determined by reference to the value, or change in value, of the personal property that is part of a straddle. In addition, fees and charges related to the maintenance of personal property are allocated to the capital account of the personal property. Where a specific allocation rule is not applicable to a transaction, the proposed regulations allocate interest expense and carrying charges to personal property that is part of a straddle in a manner that is most appropriate under all “facts and circumstances.”

The proposed regulations provide one example applying this general rule where a taxpayer holds stock and enters into an equity swap that is a short position with respect to that stock. The IRS invites comments and suggestions regarding the proposed specific and general allocation rules under section 263(g).

Obligation under a Debt Instrument as a Position in Personal Property As explained by the preamble to the proposed regulations, if a taxpayer is the obligor under a debt instrument that provides for one or more payments linked to the value of actively traded personal property, the value of the taxpayer’s obligation under the debt instrument changes as the value of the referenced property changes. For this reason, the taxpayer’s position as obligor under the debt instrument functions as a position in the referenced property. Accordingly, Prop. Treas. Reg. 1.1092(d)-1(d) explicitly provides that an obligation under a debt instrument linked to the value of personal property may be a position in personal property that is part of a straddle. The IRS views this as a clarifying addition to the regulations, and no inference is intended with respect to straddles entered into prior to the effective date of the proposed regulations. The IRS intends to finalize simultaneously attached Prop. Treas. Reg. 1.1092(d)-1(d) (regarding treatment of debt instruments as positions in personal property under the straddle rules) and Prop. Treas. Reg. 1.1092(d)-2 (regarding treatment of common stock as positions in personal property under the straddle rules). For this reason, additional taxpayer comments are invited on Prop. Treas. Reg. 1.1092(d)-2, which originally was issued in 1995.

Definition of Loss In 1985, the IRS adopted Temp. Treas. Reg. 1.1092(d)-5T(d), which defines the term “loss” for purposes of Temp. Treas. Reg. 1.1092(b)-1T through 4T as a loss otherwise allowable under section 165(a). The IRS requests comments on whether that definition should be expanded to include expenses such as interest and carrying charges or payments on notional principal contracts. The IRS also requests comments on the coordination of any such recommended changes with the

attached proposed regulations. ACTION REQUESTED: If there are comments that the Institute should submit to the IRS on the proposed regulations, please provide them to the undersigned no later than Friday, March 30, 2001 by e-mail (dflores@ici.org) or facsimile (202/326-5841). Deanna J. Flores Associate Counsel Attachment Attachment (in .pdf format)

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