

**MEMO# 1094**

April 10, 1989

## **INSTITUTE COMMENTS ON SECTION 851(G) DESIGNATED HEDGES**

- 1 - April 10, 1989 TO: TAX COMMITTEE NO. 4-89 ACCOUNTING/TREASURERS COMMITTEE NO. 15-89 RE: INSTITUTE COMMENTS ON SECTION 851(g) DESIGNATED HEDGES

As you know, section 851(g) was added to the Code by the Conference Report to the 1986 Tax Reform Act to provide limited relief from the short-short test for funds engaging in certain hedging transactions. The Institute neither requested nor had the opportunity to comment on the designated hedge rule provided in the 1986 Act. Last summer and fall, the Institute held several meetings with representatives of the Treasury Department to discuss the nature of the regulations to be drafted to implement section 851(g). The Treasury representatives informed us that they felt constrained by the statute to require that an adjustment to the basis of the hedged asset be made to reflect any netting of gain and loss done in the hedge. A meeting of interested Institute members was then held at which the conclusion was reached that any regulations under section 851(g) would be so complex as to be of essentially no value. The attached letter to the Treasury Department reflects the Institute's concern that section 851(g) will do almost nothing to relieve funds of the burdens created by the short-short test and calls, once again, for the repeal of section 851(b)(3). The letter also expresses the Institute's appreciation for the time Treasury spent discussing possible regulations under section 851(g) with us and, accordingly, passes along a few suggestions for drafting the regulations (which will, nevertheless, be of little use to most funds). The three general suggestions are that (1) any regulations should permit a fund to identify as a hedge any positions that are expected to move in opposite directions with fluctuations in the market, (2) a hedge should include both the underlying security and any number of secondary products identified as hedging that security, and (3) in applying the hedge netting rule to a portfolio of stocks hedged by an index future or option, gross gains or losses from each side of - 2 - the hedge should be netted against the gross corresponding basis adjustment to the securities to which the netting was applied. The Internal Revenue Service is working on a draft of the section 851(g) regulations that, in general, has been deemed acceptable to staff persons at both IRS and Treasury. Regulations are not expected to be issued, however, for several months at the earliest. We will keep you informed of developments. Keith D. Lawson Assistant General Counsel Attachment