

MEMO# 1240

July 17, 1989

IRS PRIVATE LETTER RULING ON CODE SECTION 851(G) DESIGNATED HEDGES

1 */ Pursuant to Code Section 6110(j)(3), a private letter ruling may not be used or cited as precedent except by the taxpayer to whom the ruling was issued. - 1 - July 17, 1989 TO: TAX MEMBERS NO. 24-89 OPTIONS AND FUTURES TASK FORCE NO. 5-89 RE: IRS PRIVATE LETTER RULING ON CODE SECTION 851(g) DESIGNATED HEDGES

Attached is the first IRS private letter ruling */1 considering what constitutes a designated hedge for purposes of Code Section 851(g) and what identification requirements will be deemed acceptable, in the absence of regulations, to establish a designated hedge. Section 851(g) provides that, in determining whether the Section 851(b)(3) short-short test has been satisfied, increases and decreases in the value of positions during the period that these positions are part of a designated hedge shall be netted. The two regulated investment companies (RICs) involved in this ruling hedge their long-term positions in 30-year U.S. Treasury bonds by investing in interest rate put options and/or short positions in interest rate futures contracts. Each RIC protects its positions in foreign securities against loss from currency fluctuations by investing in put options on foreign currencies, short positions in foreign currency futures contracts or put options on foreign currency futures contracts. One RIC protects its U.S. stock portfolio against loss by investing in put options on broad-based stock indexes (such as the S&P 500), short positions in stock index futures contracts and put options on stock index futures contracts. The ruling describes the RICs' identification procedure as follows. On the day a hedge is entered, the custodian for the [RIC] - 2 - will note that the specified hedging instruments protect specific securities identified by a transaction reference - 3 - or tax lot number. The hedging positions will be placed in a separate hedging account maintained by a futures commission merchant. The futures commission merchant or custodian for the [RIC] will confirm to the [RIC] in writing the purchase of the hedging instruments, noting the number of options purchased or futures contracts rendered, their price, the face value of the hedge, the dollar value of the portfolio positions protected by the hedging positions, and the date of the acquisition. The futures commission merchant or custodian will also designate the hedged and hedging positions identified as a designated hedge and will provide the [RIC] with written confirmation of the designation of the positions as a hedge. The written confirmation will include the date the hedge is established, the hedging positions, the hedged positions identified by transaction reference or tax lot numbers, and the market value of the hedged positions at the time the hedge is established. The private letter ruling holds first that, prior to the issuance of regulations prescribing the manner for identifying a designated hedge, the identification procedure used by the RICs in this ruling will be acceptable. The ruling then concludes that the following transactions will constitute designated hedges, provided that the values of the

positions ordinarily vary inversely with one another and appropriate identification of the designated hedges is made: (1) transactions consisting of securities denominated in a foreign currency and offsetting short positions in futures contracts, options, or options on futures contracts on that currency; (2) transactions consisting of long-term U.S. Treasury bonds and short positions in interest rate futures contracts, interest rate put options, and options on interest rate futures contracts; (3) transactions consisting of stocks held in the RIC's U.S. stock portfolio and offsetting stock index put options or short positions in offsetting stock index futures contracts. No opinion is expressed on either the application of Code Section 988 to the facts in the ruling, the appropriateness of the taxpayer's accounting principles or the procedures to be used in netting increases and decreases in the value of positions which are part of the designated hedge. - 4 - We will keep you informed of developments. Keith D. Lawson Assistant General Counsel Attachment

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