

MEMO# 9467

December 1, 1997

CONFERENCE CALL ON INTERACTION BETWEEN CONSTRUCTIVE SALE RULES AND EXCISE TAX MINIMUM DISTRIBUTION REQUIREMENTS

1 See Institute Memorandum to Tax Members No. 27-97 (among others), dated August 1, 1997. [9467] VIA FAX December 1, 1997 TO: TAX COMMITTEE No. 44-97 RE: CONFERENCE CALL ON INTERACTION BETWEEN CONSTRUCTIVE SALE RULES AND EXCISE TAX MINIMUM DISTRIBUTION REQUIREMENTS

As you may remember from the Institute's 1997 Tax & Accounting Conference, questions have arisen regarding how the Taxpayer Relief Act of 1997's new constructive sale rules (Code section 1259)¹ should be applied for excise tax minimum distribution purposes. This memorandum: (1) summarizes briefly the new section 1259 rules; (2) illustrates the issues arising from the interaction between the constructive sale rules and the excise tax minimum distribution requirements; and (3) describes possible approaches for "resolving" these issues. A conference call to discuss the issues raised in this memorandum, and any other section 1259 issues raised by Committee members, will be held on Friday, December 5, 1997, at 4:00 p.m. Please call Theresa Brice at 202-326-5833, no later than Thursday, December 4, if you wish to participate in this call. Constructive Sale Rules of Section 1259 Under section 1259, a taxpayer holding an "appreciated financial position," defined generally to include an appreciated position in any stock, debt instrument (other than straight debt) or partnership interest, is required to recognize gain upon entering into a "constructive sale." A taxpayer holding property subject to the constructive sale rule is treated as having sold and immediately repurchased the appreciated property; the taxpayer receives a new basis and holding period in the property. The closed transaction exception of section 1259(c) provides that a transaction that otherwise would be a constructive sale under section 1259 will not be so treated if: (1) the transaction is closed at any time before the end of the 30th day after the close of the taxable year in which it was entered into; and (2) for 60 days after closing the transaction: (a) the taxpayer holds the appreciated financial position and (b) at no time is the taxpayer's risk of loss reduced by holding certain other positions with respect to substantially similar or related property. If a transaction that is closed is reestablished in a substantially similar transaction during such 60 days, the RIC will have constructive sale gain as of the date the first transaction was entered - 2 - into unless the reestablished position is closed prior to the end of the 30th day after the close of the taxable year and the closed transaction exception requirements are met after such closing. Issues Arising From the Interaction of the Constructive Sale and Minimum Distribution Rules Section 1259 applies to "taxable years." As section 4982 generally treats October 31 as a taxable year-

end and applies on that date any provision that applies at the end of a RIC's taxable year (e.g., the mark-to-market rules of section 1256), section 1259 also may apply based upon an October 31 year-end. This memorandum considers issues that would arise if section 1259 were applied for excise tax purposes based upon the RIC's taxable year or, alternatively, based upon an October 31 year. Issues That Would Arise If Section 1259 Applied Only By Reference To A RIC's Taxable Year If section 1259 applied only by reference to a RIC's taxable year, a RIC making excise tax calculations might not know whether to treat a transaction occurring before November 1 as generating section 1259 gain. This uncertainty may apply, pursuant to the closed transaction exception, even if the RIC (1) has an October taxable year or (2) uses its taxable year-end of November or December for excise tax purposes. Example 1. Assume a calendar year RIC that enters into a short-against-the-box transaction on August 1. As of October 31, the date on which gains and losses are measured for excise tax purposes, the short position has not been closed. If section 1259 were applied only by reference to the RIC's taxable year, the RIC would have income arising from the constructive sale -- as of August 1 -- if (1) the RIC did not close the short position by January 30 (30 days after the close of the taxable year); or (2) the RIC closed the short position by January 30, but failed to meet the other closed transaction exception requirements. Only if the RIC closed the short position by January 30 and held the appreciated stock for an additional 60 days unhedged would constructive sale treatment be avoided. The RIC in Example 1 does not know by October 31 -- and may not know as of any date before its excise tax distribution must be made -- whether it will be required to take the constructive sale gain into account on August 1. Thus, the RIC would have no choice but to guess whether subsequent events, or nonevents, would cause or not cause the gain to be recognized as of August 1. Incorrect guesses could result in overdistributions (if the RIC incorrectly guessed that it had gain) or underdistributions (if the RIC incorrectly guessed that it did not have gain). Example 2a. Assume the same facts as in Example 1 except that the RIC has an October 31 taxable year-end. As of October 31, the RIC does not know whether it will have constructive sale income as of August 1 because it does not know whether it will close the short position by November 30 and meet the other requirements of the closed transaction exception. - 3 - Example 2b. Further assume that the RIC in Example 2a closes the short position on November 30. Even though the RIC has the same year-end for income tax purposes and excise tax purposes, it does not know by 30 days after the end of its year, and may not know until January 29 of the next calendar year (the last date on which it would know whether or not it satisfied the closed transaction exception requirements), whether it has constructive sale income on August 1. Issues That Would Arise If Section 1259 Applied Based On An October 31 Year for Excise Tax Purposes Similar "uncertainty" issues would arise if section 1259 were applied on the basis of an October 31 year for excise tax purposes. Example 3. A calendar-year RIC enters into a short-against-the-box transaction on August 1, which is not closed as of October 31. If the short position is still open at the close of business on November 30, the RIC knows that the short-against-the-box transaction results in a sale on August 1. Conversely, if the short-against-the-box transaction is closed on November 30, the RIC may not know until as late as January 29 whether it has income as of August 1 of the prior year. In addition, applying section 1259 at October 31, for excise tax purposes, and at the RIC's taxable year-end, for income tax purposes, could create two other issues. First, a RIC could have income for excise tax purposes but not for income tax purposes (which would require RICs to have "deemed" earnings and profits). Alternatively, a RIC could have income for income tax purposes but not for excise tax purposes (which could permit RICs to make lower excise tax distributions than they otherwise would be required to make). Example 4. Assume a calendar-year RIC that enters into a short-against-the-box transaction on August 1 that remains open on October 31. If the short position is not closed by November 30, the RIC will have gain for

excise tax purposes as of August 1. Further assume, however, that the RIC closes out the short position on January 30 of Year 2 (within 30 days after the close of the RIC's taxable year) and subsequently satisfies the other closed transaction exception requirements. In this situation, the RIC will not have gain as of August 1 of Year 1 for income tax purposes. This example illustrates two problems with applying section 1259 on two different dates for two different purposes. First, as the RIC does not have a gain for income tax purposes, a special rule creating earnings and profits (to support the excise tax distribution) would be needed. Second, creating an excise tax distribution requirement where the RIC does not have income for income tax purposes does not advance the legislative intent of the excise tax minimum distribution requirements, which was to prevent undue deferral of income arising for income tax purposes.

- 4 - Example 5. Assume a calendar-year RIC that enters into a short-against-the-box transaction on November 15 that is not closed until February 15. As the transaction is not closed by January 30 (30 days after the close of the taxable year), the RIC has a constructive sale as of November 15, but only for income tax purposes. If the closed transaction exception requirements are met for 60 days after February 15, however, the RIC would not have a constructive sale for excise tax purposes.

Possible Approaches for "Resolving" these Issues The Institute has identified several approaches that could be advanced for resolving these excise tax/section 1259 reconciliation issues. These approaches vary in the degree to which they provide: (1) certainty, as of certain dates (such as October 31), regarding the amount of income to be included for excise tax purposes; (2) consistent treatment of transactions for income tax and excise tax purposes; and (3) consistency with the tax policy objectives of sections 1259 and 4982.

Approach 1: Include Within Excise Tax Distribution Requirement Only Those Section 1259 Gains That Are Known as of October 31 One approach would be to include within the excise tax distribution requirement only those section 1259 gains that are certain, for income tax purposes, as of October 31, with any section 1259 gains subsequently determined as arising on or before October 31 as being realized on the first day of the RIC's next taxable year. This approach, absent modification, may be viewed unfavorably by some as RICs could enter into constructive sales where the resulting income would not be distributed until the calendar year after the calendar year in which it would arise under section 1259 (see Example 7).

Example 6. A calendar-year RIC enters into a short-against-the-box transaction on August 1, that is closed on October 15. On October 30, the RIC buys a put on the same stock that it shorted on August 1. As the RIC knows before October 31 that it did not meet the closed transaction exception with respect to the October 15 closing of the short-against-the-box transaction, the RIC treats its section 1259 gain as arising on August 1.

Example 7. Assume the same facts as in Example 6, except that the RIC buys the put on November 30, rather than October 30. In this case, as the RIC does not know by October 31 that it will not meet the closed transaction exception with respect to the October 15 closing of the short-against-the-box transaction, the RIC would treat its section 1259 gain as arising on January 1.

Approach 2: Include Within Excise Tax Distribution Requirement All Transactions Which, as of October 31, Either Generate or May Generate Section 1259 Gains An alternative approach would be to include within the excise tax distribution requirement all transactions which, as of October 31, either generate or may generate section 1259 gains and treat all such gains as income for income tax purposes. If section 1259 would not apply to a transaction based upon the RIC's taxable year (i.e., because the closed transaction exception would be met for the taxable year), the RIC would receive an offsetting loss (equal to the amount of gain recognized under section 1259) -- for both income tax and excise tax purposes -- as of the first day of the next taxable year. The difference between Approaches 1 and 2 is with respect to the transactions for which the closed transaction exception could still be met after October 31. The second approach includes those transactions within the excise tax distribution requirement (with a possible offsetting loss in

the next taxable year), while the first approach excludes them (with possible income on the first day of the next taxable year). Example 8. Assume a calendar-year RIC that enters into a short-against-the-box transaction on August 1 that remains open as of October 31. Since the RIC cannot know, as of October 31, whether it will close the transaction before January 30 and then meet the other closed transaction exception requirements, the RIC must recognize income as of August 1 on the shorted stock. If the RIC closed the transaction before January 30 and held the underlying stock unhedged for an additional 60 days, the RIC would be treated as incurring an offsetting loss on January 1 (the first day of the RIC's next taxable year). Example 9. Assume the same facts as in Example 7. A calendar-year RIC enters into a short-against-the-box transaction on August 1, that is closed on October 15. Since the RIC cannot know, as of October 31, whether it will continue to hold the stock unhedged for another 44 days (to meet the closed transaction exception), the RIC must recognize income as of August 1 on the shorted stock. If the RIC continued to hold the stock unhedged through December 14 (so that the closed transaction exception were met), the RIC would be treated as incurring an offsetting loss on January 1 (the first day of the RIC's next taxable year). Approach 3: Make Determinations Under Approach 1 or 2 On November 30 Approach 3, a variation on the first two approaches, looks to knowledge as of November 30 (rather than on October 31) in applying section 1259 (Approach 2) or not applying section 1259 (Approach 1) to situations where application of the rule otherwise cannot be determined. Example 10. Assume the same facts as in Example 7, where the RIC closes a short-against-the-box transaction on October 15 and then, on November 30, buys a put on the same stock that it shorted on August 1. As the RIC knows by November 30 that it has not satisfied the closed transaction exception, the RIC has constructive sale income as of August 1 (rather than as of the next January 1, as in Example 7) that must be included in its excise tax calculations for the calendar year. - 7 - Approach 4: Place a Cap on Income that May Possibly be Deferred under Approach 1 (Perhaps as Modified by Approach 3) Approach 4 would impose a cap on the amount of potential section 1259 gain that would qualify for the treatment provided by either Approach 1 or Approach 3's variation on Approach 1. For example, Approach 4 could provide that all transactions to which application of section 1259 cannot be determined as of October 31 (or November 30) will be treated as constructive sales under section 1259 for excise tax purposes unless the amount of "undetermined gain" is less than some percentage (such as 5 percent) of the RIC's income for excise tax purposes. ACTION REQUESTED If you wish to participate in the conference call to be held on Friday, December 5, 1997, at 4:00 p.m., please call Theresa Brice at 202-326-5833 no later than Thursday, December 4, and provide her with your name and the telephone number at which you may be reached for the call. If you would like to provide the Institute with input on these issues, but cannot participate in the call, please call the undersigned at 202-326-5832. Keith D. Lawson Associate Counsel - Tax