News Analysis: Temporary Mixed Straddle Rules Knock Out Loss Freshener

by Lee A. Sheppard and Jaime Arora

There will be no more using identified mixed straddles to freshen expiring net operating losses. Long overdue temporary mixed straddle regulations would segregate pre-identification gain and loss from post-identification gain and loss. This would prevent taxpayers from using identified mixed straddles as an alternative to selling assets to accelerate gain or loss.

Treasury and the IRS on August 1 issued temporary regulations (T.D. 9627) that explain how to account for unrealized gain or loss on a position held by a taxpayer before the time the taxpayer establishes a mixed straddle using straddle-by-straddle identification. The text of the temporary regulations also serves as the text of concurrently issued proposed regs (REG-112815-12).

The temporary guidance adds new reg. section 1.1092(b)-6T, which provides that unrealized gain or loss on a position that becomes part of a section 1092(b)(2) mixed straddle should be recognized at the time directed by the provisions of the code that would apply if the mixed straddle had not been established. Therefore, pre-straddle gain or loss will be accounted for under other provisions of the code, and gain or loss incurred while the straddle is in place will be accounted for using the straddle rules of section 1092.

History

Under the regulations that had been in place since 1985, unrealized gain or loss on a position that becomes a position in a section 1092(b)(2) mixed straddle was required to be recognized on the day prior to establishing the straddle (reg. section 1.1092(b)-3T(b)(6)). Although this approach is suggested by the legislative history of section 1092, it arguably permits taxpayers to selectively recognize gains and losses in inappropriate circumstances and without market constraints.

David Golden of EY noted Treasury and the IRS's acknowledgement that current recognition treatment "is suggested" by the legislative history, not required. He said that in his view, the new regulations are contrary to the very clear legislative history under section 1092.

The legislative history states that Congress intended that built-in gain or loss should be recognized at the time the mixed straddle is created, Golden said. While there's no question that Treasury does have a broad grant of regulatory authority to write mixed straddle regulations, Congress clearly believed that the regulations would be more consistent with the old rules.

New reg. section 1.1092(b)-6T will apply to all section 1092(b)(2) identified mixed straddles established after August 1, 2013. Comments are due by October 31, and a hearing is scheduled for December 4.

The Shelter

In a normal market situation, taxpayers are not usually eager to accelerate gains because that would not be to their advantage, said Erika W. Nijenhuis of Cleary Gottlieb Steen & Hamilton LLP. However, the past few years have not been normal, she said.

During the financial crisis, many companies experienced capital losses, Nijenhuis said, adding that some of those losses are scheduled to expire soon. At the same time, some bond portfolios contain a lot of built-in gain because the Federal Reserve has kept interest rates low, she said. Taxpayers have used the identified mixed straddle rules to accelerate gains on their bond portfolios in order to absorb their expiring capital losses.

Nijenhuis explained that the use of an identified mixed straddle can also have the effect of essentially refreshing a taxpayer's basis in its capital assets. When a taxpayer is deemed to have sold its bond portfolio, it gets a higher basis in the assets, she said. The taxpayer can then either treat the difference as bond premium and deduct it over time, or recognize a loss when the assets are actually sold, she said.

The regulations in their prior form were very favorable to that kind of transaction, Nijenhuis said, adding that many taxpayers had put on identified mixed straddles. It was an example of the general rule that if there is a noneconomic rule in the tax code, someone will find a way to take advantage of it, she said.

Golden said gain acceleration was not the only issue that the government likely considered. Over the years, taxpayers have also used the identified mixed straddle rules to accelerate losses because they work both ways, he said. The government decreed that the use of the straddle rules by an increasing number of companies to recognize otherwise unrealized gains or losses in their investment portfolios is not appropriate, Golden explained.

The use of identified mixed straddles to accelerate losses was very popular with insurance companies. The trick was to have limited risk on the other leg of the straddle while accelerating gain to use against expiring loss carryovers. Taxpayers often used safe assets like Treasury securities for the gain leg, limiting their unhedged exposure through short holding periods (reg. section 1.1092(b)-3T(b)(4), Example 1).

"There is also a significant non-tax advantage that taxpayers have been looking at with the old rule," said Mark Leeds of Mayer Brown. "Specifically, under the Basel III standards, taxpayers suffer a significant capital charge against deferred tax assets, such as NOLs."

Leeds explained that if a taxpayer could trigger gain on its assets to use up the NOLs reported as deferred tax assets, it would alleviate the need to set aside capital against the deferred tax assets. "Although the IRS should not have any problems with such a transaction, this accounting strategy will be curtailed by the new rule," he said.

Ramifications

Monte A. Jackel of Monte A. Jackel Federal Tax Advisory Services LLC was troubled that the regulations' drafters did not explain what would happen to loss acceleration transactions that predated the temporary regulations. "What does the IRS intend to do about this? If the intent was to concede the prior transactions, the IRS should have explicitly said so," he wrote on his blog at jackeltaxlaw.com.

Some practitioners took the position that these transactions would not hold water under common-law doctrines such as substance over form, but they were outvoted by financial specialists and taxpayers with losses on their books. Jackel wondered whether the government intends to litigate the older transactions.

"Does the effective date of the new temporary regulations mean that the pre-issuance transactions are now in question, or alternatively, does the effective date mean that the pre-issuance transactions are immune from attack? Or does it mean that the IRS has just not decided yet?" Jackel wrote.

Jonathan Zelnik of KPMG LLP said that he understands the government's reason for making a change if it is concerned that taxpayers have had the opportunity to trigger gains or losses on a one-time basis without changing their economic position. However, the new rules may pose some record keeping burdens for taxpayers as they attempt to track their pre-straddle gains or losses, he said.

Agreeing that the rules create an additional compliance burden, Golden said that taxpayers must remember the suspended gain or loss will need to be built into the basis of their capital assets going forward but won't be recognized until some point later.

Discussing another consequence, Nijenhuis said that the new regulations seem to make the so-called holding period killer rules even more of a killer (reg. section 1.1092(b)-2T). The temporary regulations effectively restart the taxpayer's holding period on its non-hedge position even if it has already held it long enough to be considered long term, she said.

Nijenhuis said that approach differs from the current rules, which allow a taxpayer to continue its holding period on the position if it was already considered long term. She speculated that this might be inadvertent because Treasury did not affirmatively state its intention to achieve that result. The temporary regulation merely cites the current holding period rule.

"The change in the rule could prompt taxpayers to try to make affirmative use of the *Anschutz* decision. The *Anschutz* court found that a busted section 1058 securities lending transaction was treated as a taxable sale followed by a separate repurchase transaction," said Leeds. (*Anschutz Co. v. Commissioner*, Nos. 11-9001, 11-9002 (10th Cir. Dec. 27, 2011), aff'g 135 T.C. 78 (July 22, 2010).)

A Change of Heart?

Practitioners questioned the seeming inconsistency between the temporary regulations and recent reform proposals, including the derivatives discussion draft issued by House Ways and Means Committee Chair Dave Camp, R-Mich., in January.

These rules seem to take the opposite approach to a reform idea that President Obama presented in his fiscal 2014 budget. In that proposed reform of financial and insurance industry institutions and products, a derivative contract that is embedded in another financial instrument or contract would be marked to market if the derivative by itself would be marked.

Also, a financial instrument that is not otherwise marked to market that is part of (or becomes part of) a straddle including a derivative contract would be marked to market. Preexisting gain would be recognized at that time, while loss would be deferred until the financial instrument is otherwise disposed of. The Camp derivatives draft contains the same treatment.

Some practitioners noted that the temporary regulations' prohibition on recognition of built-in gain when the taxpayer identifies a mixed straddle is not well-coordinated with the reform proposals.

The new regulations are inconsistent with what the government has previously proposed, Nijenhuis said. It doesn't make sense for the administration to propose to accelerate gain when Treasury is stating that gain recognition is a problem.

Golden countered that the government ought to be commended for maintaining parity in the treatment of gains and losses in the new rules instead of taking a revenue-raising approach of requiring the acceleration of gains but the deferral of losses.

Given Treasury's input in the budget process, Zelnik wondered whether the new regulations signal that the administration may have changed its thinking in regards to gain recognition involving straddles.

"While the temporary regulations are targeted to taxpayers using the identified mixed straddle rules to accelerate losses, their chief interest is what they can tell us about the pitfalls of a tax system that arbitrarily divides the world between mark to market and realization treatment of assets and transactions," said Viva Hammer of Brandeis University. "The drafters of tax reform should take note."

"The Camp derivatives proposal would expand the universe of mixed straddles in exactly this situation -- with derivatives that are marked to market and assets like stocks that are not," Hammer said. "The regulation raises the problems with this hybrid approach to the financial world, but a regulation won't be enough to fix the problem."