IN PRACTICE

U.S. Tax Aspects of Equity Derivatives

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An equity derivative is an instrument that is not itself a share of stock, but whose value is derived from the value of one or more shares of stock. The varieties of such contracts have proliferated significantly in the 1990s, so that the market place not only offers the traditional convertibles and warrants, but also stock index products, unbundled stock units, swaps and numerous hybrid products.

This article addresses three basic types of equity derivatives: options, forwards/futures and swaps. Each is examined from the perspective of several fundamental tax questions: timing (when is income/loss taken into account), character (capital or ordinary income/loss), source (is the income/loss sourced within or outside the U.S.), withholding, and tax ownership.

Timing

The general principle of U.S. federal taxation is that a taxpayer should have a realizable event before a tax is imposed. This realization principle is so heavily eroded in the area of financial transactions, however, that there are now probably more transactions that fall under the exceptions than within the general rule. For example, securities dealers must account for their gains and losses using a mark-to-market system, and securities traders are permitted to elect to use such a system. Similarly, "§1256" contracts must be marked to market at year end and at certain other times. In addition, the straddle rules prevent the recognition of loss on the sale of one asset to the extent that a taxpayer has an unrecognized gain in an "offsetting position." Recently, Congress passed the "constructive sale" rules of §1259, which require recognition of gain where there are certain transactions with respect to appreciated property, even when the taxpayer clearly has title to that property and does not intend to dispose of it.

Many commentators criticize the piecemeal rules for determining the correct time for taking into account gain and loss for taxation purposes, and suggest that there should be a consistent rule, providing either for cash-flow or mark-to-market taxation.[1] However, the likelihood of comprehensive tax reform in this area is remote, and so practitioners continue to sort through a maze of rules to determine when a taxpayer reports gain and loss on its tax return, and how much gain and loss should be reported.

Character

The distinction between ordinary income or loss and capital gains and losses is significant for a number of reasons under U.S. federal income tax law. For individuals, the maximum tax rate on ordinary income is 39.6%, while the minimum rate for long term capital gains for those in the same tax brackets is 20%.[2] In addition, an individual is only permitted to deduct capital losses against capital gains, plus $3,000 of ordinary income.[3] A corporation is only permitted to deduct capital losses against capital gains, but there is no rate differential.

Withholding

The U.S. federal government imposes a 30% withholding tax on certain types of U.S. source income unless the income is effectively connected with the conduct of a U.S. trade or business or the tax is reduced or exempted by treaty. The types of U.S. source income that are subject to withholding include interest, dividends, rents, salaries, wages and other "fixed or determinable annual or periodical gains, profits or income" (known in the tax world as

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[1] See Warren, "Financial Contract Innovation and Income Tax Policy," 107 *Harv. L. Rev.*, p. 460 (1993).

[2] Although the long term capital gains rates for those in lower tax brackets drops to 15%. §1.

[3] §1211(b).

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"FDAP"). Although FDAP is not defined anywhere, practitioners ask as a rule of thumb whether the income in question has a high ratio of net income to gross income (*i.e.*, there are few significant deductions attributable to the income).

Tax Ownership

Tax law has developed its own analysis to determine who owns property. The indicia of tax ownership developed by the courts and IRS focuses on the benefits and burdens of ownership, as well as legal title, and the right to dispose of the property. For stock, indicia of ownership also includes the right to vote the shares, obtain information from the company, sell, pledge or otherwise use the stock, and obtain distributions upon liquidation.

OPTIONS

Timing

The general principle is that a taxpayer does not realize taxable income upon the receipt of an option premium.[4] If the option expires unexercised, the premium income, less fees and commissions,[5] becomes income to the grantor on the date of expiration, and is included in income in the year of the expiration.[6] The amount of income realized by the option grantor upon the exercise of an option includes the amount of the premium less commissions and fees. These amounts are added to the amount paid for the underlying stock, and the taxpayer will have a gain if the strike price plus premium is greater than its basis in the stock sold, or a loss if the strike price plus premium is

The treatment of option purchasers mirrors that of option grantors. The mere payment of a premium plus commissions and fees for an option does not trigger any tax consequences. If the option expires unexercised, the taxpayer is treated as if it disposed of the option on the expiration date.[7] Purchasers will therefore have a loss for the amount of the option premium, plus commissions and fees in the year the option expired. If the option is exercised, no gain or loss is recognized, but the premium plus commissions and fees are included in the basis of the stock acquired.[8]

Cash Settlement Options

While the exercise of a physically settled equity option has no immediate tax consequence, the exercise of a cash-settled option is treated as the sale or exchange of the option. Therefore, the taxpayer will have taxable gain or loss upon such exercise.[9]

The exceptions to these general rules are numerous, and include the following:

Options that Are Part of a Tax Straddle

The U.S. tax law provides for special treatment of "offsetting positions in personal property."[10] Most particularly, for tax purposes, a taxpayer will not be able to deduct currently a loss sustained in a transaction on one of the positions in a straddle to the extent of unrealized gains in any other offsetting positions;[11] it must capitalize all expenses associated with carrying positions that are part of a straddle;[12] and its holding period on any position that is part of a straddle does not begin to run until the position ceases to be part of the straddle.[13]

For these purposes, a taxpayer will be considered to hold "offsetting positions with respect to personal property" if holding one of the positions substantially diminishes the taxpayer's risk of loss from holding any other position.[14] "Personal property" is any property of a kind that is actively traded.[15] Stock is not included in the definition of personal property unless:

☐ The stock is stock in a corporation formed or availed of to take positions in property which offset the taxpayer's other positions;[16] or

☐ The straddle consists of stock and an option with respect to that stock or substantially identical stock;[17] or

☐ The straddle consists of stock and a position with respect to "substantially similar or related property other than stock."[18]

The definition of "substantially similar or related property" is contained in regulations issued in 1995.[19] These regulations provide that, in general, property is substantially similar or related to stock when:

☐ The fair market values of the stock and the property primarily reflect the performance of —

- A single firm or enterprise;
- The same industry; or
- The same economic factors; and

[4] Rev. Rul. 78-182, 1978-1 C.B. 265, Rev. Rul. 58-234, 1958-1 C.B. 279, Rev. Rul. 71-521, 1971-2 C.B. 313.
[5] Rev. Rul. 58-234, 1958-1 C.B. 279, Rev. Rul., 68-151, 1968-1 C.B. 363.
[6] Rev. Rul. 78-182, 1978-1 C.B. 265.
[7] §1234(a)(2).
[8] Rev. Rul. 78-182, 1978-1 C.B. 256, Rev. Rul. 58-234, 1958-1 C.B. 279, Rev. Rul., 68-151, 1968-1 C.B. 363.

[9] §1234(c)(2)(B).
[10] §1092.
[11] §1092(a)(1)(A).
[12] §263(g).
[13] Regs. §1.1092(b)-2T(a)(1).
[14] §1092(c)(2).
[15] §1092(d)(1).
[16] §1092(d)(3)(B)(ii).
[17] §1092(d)(3)(B)(i)(I).
[18] §1092(d)(3)(B)(i)(II).
[19] Regs. §1.246-5.

☐ Changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property or a fraction/multiple thereof.[20]

These regulations provide special rules to determine whether a position reflecting the value of a portfolio of stocks (*e.g.*, an option on the S&P 500) is "substantially similar or related" to the particular stocks that make up a taxpayer's portfolio.

The straddle rules do not apply to certain straddles consisting of qualified covered call options and the optioned stock. A qualified covered call option is an option granted by the taxpayer to purchase stock held by the taxpayer if the option is traded on a national securities exchange; the option is granted more than 30 days before the day on which the option expires; the option is not a deep-in-the-money option; the option is not granted by an options dealer in connection with its dealer activity; and gain or loss with respect to the option is not ordinary income or loss.[21]

Options that are also "§1256 Contracts"

Stock options may not be subject to the general rules if the options are "§1256 contracts." Section 1256 contracts must be marked-to-market at year end, or when the taxpayer's rights are terminated or transferred during the year by offsetting, by taking or making delivery, by exercise or by being exercised, by assignment or by being assigned, by lapse or otherwise. Options on individual stocks, even if listed on a U.S. exchange, are not required to be marked to market, because §1256 defines quite narrowly the kinds of equity options that come within its ambit, namely:

☐ "Dealer equity options," *i.e.*, an equity option granted or purchased by an options dealer in the course of the dealer's activity as a market maker or specialist in listed options; [22] and

☐ "Nonequity options", *i.e.*, in this context, a stock index option listed on a U.S. exchange.[23]

Dealers or Traders in Securities

Taxpayers which are considered "dealers in securities" are subject to mark-to-market treatment on their securities portfolio. A "dealer" for these purposes is a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[24] A security includes stock, evidence of indebtedness, swap, or other derivative instrument on stock or debt.[25] An equity option could be part of a dealer's portfolio, and unless the option is held by the taxpayer as an investment,[26] or is a hedge of a security held for investment,[27] the taxpayer treats the option as if it sold for its fair market value on the last business day of the taxable year, and takes the resulting gain or loss into account in that year.[28]

Under the Taxpayer Relief Act of 1997, a trader in securities is also entitled to elect mark-to-market treatment on its trading portfolio. A trader is somewhat circularly defined as "a person who is engaged in a trade or business as a trader in securities." [29] A trader who elects mark-to-market treatment may avoid marking a security to market if the trader establishes to the satisfaction of the Secretary of the Treasury that that security has no connection to the activities of the taxpayer as trader, and specific same-day identifications are complied with.[30]

Options on a Taxpayer's Own Stock

Options on a taxpayer's own stock are subject to special statutory rules. If a taxpayer grants an option to another party to purchase the taxpayer's stock and the option is purchased back by the taxpayer, or lapses, the taxpayer has no gain or loss.[31] There should also be no tax consequence if the option is cash settled on the exercise date.[32] Similarly, if the taxpayer grants an option allowing the purchaser to put the taxpayer's stock back to the taxpayer, there should be no tax consequence on the repurchase or lapse of the option, or its cash settlement, although this latter rule is implied rather than explicitly provided in the statute.

Tax practitioners have assumed that if a taxpayer purchases a put or call option on its own stock, there should be no tax consequence upon lapse, or exercise of such an option, whether physically or by cash settlement, although authority for this conclusion is unclear. It has been suggested that because of the lack of authority on this point, taxpayers could argue that gains resulting from transactions relating to a taxpayer's purchase of options on its own stock should be sheltered from taxation, while losses would be deductible, although this result clearly violates the spirit of the statute and would undoubtedly be challenged.[33]

Wash Sale Rules

The Internal Revenue Code has had rules to prevent the recognition of tax losses using closely timed

[20] Regs. §1.246-5(b)(1).
[21] §1092(c)(4).
[22] §1092(a)(3)(A)(ii).
[23] §1256(g)(3).
[24] §475(c)(1).
[25] §475(c)(2).
[26] §475(b)(1)(A).
[27] §475(b)(1)(C).
[28] §475(a)(2).
[29] §475(f)(1)(A).
[30] §475(f)(1)(B)
[31] §1032.
[32] Rev. Rul. 88-31, 1988-1 C.B. 302.
[33] See Schler, "Exploring the Boundaries of Section 1032," 49 *Tax Law*, pp. 543-627.

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sales and repurchases of stock since 1921. However, in 1988, Congress introduced the same rule for the sale and repurchase of stock options. Section 1091 now provides that no loss is allowed from the sale of stock, or contracts or options to acquire or sell stock if, within a period beginning 30 days before the sale, and ending 30 days after the sale, the taxpayer has acquired, or entered into a contract to acquire, substantially identical stock or contracts or options to acquire or sell stock.

There is some question about what constitutes "substantially identical securities" in the context of options. One prominent commentator, adapting the seminal Black-Scholes option model[34] to the tax law, suggests that options with maturity dates and/or strike prices that are different by more than a de minimis amount should not be considered substantially identical, although he cites a contrary GCM.[35]

Character

Gain and loss associated with the sale, disposition, lapse, exercise, etc., of an option has the same character of the property which is the subject of the option.[36] Therefore, if the equity interest to which the option relates is a capital asset in the taxpayer's hands, the gain or loss from the option will also be capital. This is true whether the option is cash or physically settled.

If the option is a §1256 contract, *i.e.*, a broad-based stock index option that fits within the definition of "nonequity option," or a dealer equity option, its character will be 60% long term capital gain or loss and 40% short term capital gain or loss, irrespective of how long it has been held by the taxpayer, or what the character of the option or underlying property would otherwise be in the taxpayer's hands.

If the option is non-investment property in the hand of a securities dealer,[37] or a hedge of ordinary property held by the dealer, gain and loss with respect to the option will be ordinary.[38]

Withholding

There is no authority as to whether income received by a foreign person upon sale, or cash settlement of an option, constitutes FDAP and is, therefore, subject to withholding tax. Moreover, there are no specific rules relating to the sourcing of income realized with respect to an option. The U.S. Treasury has authority to issue sourcing rules for options, forwards and futures contracts, but this authority has not been exercised. Therefore, income realized under options, forwards and futures contracts is sourced under the general sourcing provisions of the Internal Revenue Code. Under §865(a), income from the sale of personal property is sourced according to the residence of the taxpayer. In order for §865(a) to apply, the income must result from the sale of personal property. Under general principles, income from the cash settlement of an option or forward is not considered income from the sale of property. However, an argument could be made, based on an interpretation of the newly amended §1234A of the code, that to the extent that the option is a capital asset in the taxpayer's hands, income from the expiration, lapse, or other termination of the option is income from the sale of such property.[39] To the extent the option is an ordinary asset in the taxpayer's hands,[40] it is necessary to determine whether the income from the option is FDAP. There is, unfortunately, no clear guidance on this point.

For many taxpayers, the question of withholding is resolved by Treaty rather than domestic law. Under the 1996 U.S. Model Treaty,[41] income from financial instruments not specifically covered by another Treaty article will be covered by Article 21 "Other Income" and will be subject to income tax only in the country of residence of the recipient. For taxpayers whose option gains or losses are generated by a business in dealing in such instruments, the income or loss may be covered by the "Business Profits" articles of the Model or other relevant treaty.[42]

Tax Ownership

If a taxpayer purchases a call option with respect to stock, it will not be considered to own that stock until the option is exercised, and the holding period on the stock will not begin to run until that date.[43] Similarly, the purchaser of a put option will not be considered to have sold the property until the option is exercised. However, if it is virtually certain that the option will be exercised, the option will be treated as a forward contract, *i.e.*, the taxpayer may be treated as contracting to sell/buy the stock on the strike date for the sum of the premium and the strike price.[44]

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[34] As analyzed in Note, "Wash Sales and Stock Options: How Does the "Substantially Identical" Rule Apply?" 42 *Tax Law*, p. 1073 (1989).

[35] See Kleinbard, "The U.S. Taxation of Equity Derivative Instruments" in *The Handbook of Equity Derivatives*, Jack Clark Frances, et. al., Chicago: Irwin, 1995, at p. 545.

[36] §1234(a)(1).

[37] There are complex rules to determine whether property held by a dealer in securities is subject to the general mark-to-market/ordinary character regime or otherwise. Identifications and elections may have to be made. The practitioner concerned about these issues should read §475 and the regulations thereunder in greater detail than the outline contained here can provide.

[38] Regs. §1.1221-2.

[39] This conclusion follows from an interpretation of §1234A.

[40] If, for example, the taxpayer is a dealer in securities.

[41] The U.S. Model Income Tax Convention of September 20, 1996.

[42] Article 7 of the 1996 Model Treaty.

[43] §1223(6).

[44] Rev. Rul. 82-150, 1982-2 C.B. 110, Rev. Rul. 85-87, 1985-1 C.B. 268.

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Forwards

Timing

A taxpayer entering into a forward contract (*i.e.*, a non-exchange traded contract) to buy or sell stock does not have to recognize gain or loss on the contract until it is terminated, assigned, offset, etc., *i.e.*, there is no requirement to mark the contract to market or otherwise accrue the gain or loss until the contract is disposed of in some way.

If the taxpayer delivers the stock under the forward contract, it will recognize gain and loss at that time, in an amount equal to the difference between the amount received under the contract, and its basis in the stock. If the taxpayer purchases stock under the forward contract, the amount paid for the stock will become its basis in the asset, and no gain or loss need be recognized at the time that it accepts delivery of the stock.[45]

If the taxpayer cash-settles the contract, either on or prior to the settlement date provided under the contract, gain and loss will be recognized at the time of the cash settlement. A taxpayer could offset its position under the forward contract by entering into an equal but opposite forward contract with another party. Under the common law, it is uncertain whether this kind of transaction would constitute a true termination giving rise to immediately recognizable gain or loss, because of the potentially different counterparty risks under the two forward contracts. Under the new constructive sale rules of §1259, entering into such an equal and offsetting contract would almost certainly constitute a constructive sale, if the original forward contract were an "appreciated financial position." Consequently, the taxpayer would be required to recognize taxable gain in the year of offset.

To the extent that a taxpayer is a dealer in securities, it may be required to mark the forward contract to market, unless the contract is held by the taxpayer as an investment, or as a hedge of an investment.[46]

Character

A forward contract on stock is an executory contract. In general, in order to obtain capital gain or loss on a transaction, a taxpayer must have a sale or exchange of a capital asset.[47] However, under a special statutory rule, gain or loss attributable to cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of a taxpayer, is treated as gain or loss from the sale of a capital asset.[48] Except for forward contracts entered into by dealers in stock, most terminations and other disposals of forward contracts on stocks will fit within this latter rule, and will generate capital gain or loss for taxpayers.

Withholding

As discussed above, in order to determine whether income to a non-U.S. person is subject to withholding tax, it has to be decided whether the income is sourced within or outside the U.S. Under §865(a), income from the sale of personal property is sourced according to the residence of the taxpayer. In order for §865(a) to apply, the income must result from the sale of personal property. Under general principles, income from the cash settlement of a forward contract is not considered income from the sale of property. However, an argument could be made to the extent that the forward contract is a capital asset in the taxpayer's hands, income attributable to the cancellation, lapse, or other termination of the forward is income from the sale of such property.[49] To the extent that the forward is an ordinary asset in the taxpayer's hands,[50] it is necessary to determine whether the income attributable to the settlement of the forward is FDAP. It could be argued the income received from a cash-settled forward contract is FDAP because there would be a high ratio of net income to gross income given the lack of significant deductions attributable to the income received. However, there is no authority on this point, and, as for the discussions on the options, many of these issues will be resolved under the particular income tax treaty that governs the taxation of the parties to the transaction.

Tax Ownership

Entering into a forward contract of publicly traded property will not immediately transfer title to that property, since legal title is necessary in order to deal with the property in the future.[51] It generally will not transfer tax ownership, either.

Futures Contracts

Timing

Since there are no futures contracts on individual stocks in the U.S., the only relevant equity futures are

[45] *Bernuth Lembcke Co., v. CIR*, 1 B.T.A. 1051. (1925) (acq. IV C.B. 3).
[46] §475.
[47] §1222.
[48] §1234A.
[49] This conclusion follows from an interpretation of §1234A.
[50] If, for example, the taxpayer is a dealer in securities.
[51] Rev. Rul. 73-524, 1973-2 C.B. 307, Rev. Rul 72-478, 1972-2 C.B. 487.

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index futures contracts, *i.e.*, contracts in which one party pays and one party receives cash based on the change in value of an index based on the prices of a portfolio of stocks. All such futures contracts are §1256 contracts. This means that they would have to be marked to market at year end, and after various other termination events, and gain or loss would be taken into account at that time, as described above for options.

Character

All gains on §1256 contracts receive the same characterization, *i.e.*, 60% long term capital gain and 40% short term capital gain.

Withholding

The discussion above for forward contracts is equally applicable to futures contracts.

Tax Ownership

The discussion above for forward contracts is equally applicable to futures contracts.

Swaps

Timing

Special rules have been promulgated by the Treasury to determine the correct timing for taking into account income and loss from a "notional principal contract." Although the definition of "notional principal contract" is fairly broad, there are certain types of contracts which traders call "swaps" that would not fall within this definition. When assessing the tax impact of an equity financial instrument, therefore, it is important to determine first whether it is a notional principal contract, and if not, what other characterization is appropriate.

A notional principal contract is defined in regulations as a financial instrument that provides for payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[52] Equity swaps are explicitly listed as intended to be included in this definition.[53] Several elements of this definition deserve further discussion:

- A notional principal contract only requires one party to make regular payments. As long as the other party makes some promise, or transfers other good consideration, there is no need for both parties to make regular payments. This sometimes occurs where one party agrees to make regular payments and there is a single payment between the parties at termination representing the appreciation/depreciation on an underlying stock.

- A specified index can be a rate, price, or amount that is constant throughout the life of the contract, or changes from period to period. It can also be an index that is based on current, objectively determinable financial information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances (*e.g.*, one of the party's dividends, profits or the value of its stock.)[54]

- A notional principal amount is any specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract, but is not borrowed or loaned between the parties as part of the contract. The notional amount can vary over the term of the contract, provided that it is set in advance or varies based on objective financial information.[55]

Most equity swaps will fall under this definition. However, certain types of swaps will not. For example, a contract with a notional principal of $1 million, in which one party receives, at the end of two years, the total return of the TOPIX (broad-based Japanese stock index) and pays the total return of a narrow basket of fifty Japanese stocks (Nifty-fifty). Since there is no "payment of amounts by one party to another at specified intervals," the contract is not a notional principal contract. Although not completely clear, such a contract might be treated as an executory contract, with gains and losses taken into account on a realization basis.

Payments under notional principal contracts are taken into income under three different regimes, depending on whether they are "periodic" payments, "nonperiodic" payments or "termination" payments.

Periodic payments are payable at intervals of one year or less during the entire term of the contract, are based on a specified index and on a single notional principal amount or a notional principal amount that varies over the term of the contract in the same proportion as the notional amount that measures the other party's payments.[56] Taxpayers are required to recognize the daily portion of a periodic payment for the taxable year to which that portion relates.[57] This means that the total periodic payment due by each party is netted, then divided by the number of days in the payment period, and then multiplied by the num-

[52] Regs. §1.446-3(c)(1)(i).
[53] Regs. §1.446-3(c)(1)(i).
[54] Regs. §1.446-3(c)(2) and Regs. §1.446-3(c)(4)(ii).
[55] Regs. §1.446-3(c)(3).
[56] Regs. §1.446-3(e)(1).
[57] Regs. §1.446-3(e)(2)(i).

The general rule is that income from a notional principal contract is sourced according to the residence of the recipient of the income. Therefore, if a U.S. person makes a net payment to a foreign person under the swap, the payment will be sourced outside the U.S. and will attract no withholding tax. However, if the income from the notional principal contract is effectively connected with a U.S. trade or business, the income will be U.S. source.[75] If the foreign person makes a net payment to the U.S. counterparty, the payment will be generally be U.S. source.

Tax Ownership

There are many types of equity swaps on the market, and parties make various arrangements as to the types of periodic and final payments that are agreed to be made. It is common to see one party paying dividends periodically, and any appreciation in the value of the stock at termination, and the other party making an interest-like payment periodically, and making the counterparty whole for depreciation in the value of the stock at termination. In economic terms, this looks very much like a sale of the stock, since one party passes onto the other all the benefits of stock ownership and is insured against any detriments. However, even if the party paying the dividends and appreciation owned the stock which is the subject of the swap, if it retains the following rights with respect to the stock, it will probably still be considered the tax owner of that stock: the ability to sell, or otherwise deal with and use the shares; obtain information from the company; vote the shares; receive distributions upon liquidation; and receive dividends from the company.[76]

[75] Regs. §1.864-4(c).

[76] Rev. Rul. 83-47, 1983-1 C.B. 63.

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