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Tax

Tax Practitioners Discuss Taxation of Swaps, Wash Sales, Constructive Sales, Short Sales and Straddles at FRA/HFBOA Seminar (Part Four of Four)

By Vincent Pitaro

As a general matter, investors prefer long-term capital gains over ordinary income and, when faced with losses, short-term losses over long-term capital losses. Investors and tax professionals are constantly seeking to optimize their tax results, in part by seeking to assure the most favorable tax treatment available when trading. In some circumstances, such as those involving total return swaps, the IRS has simplified matters by predetermining a fixed percentage of gains and losses that are entitled to short-term or long-term treatment. The IRS has also adopted several rules over the course of the last century in response to trades that generated tax benefits but that did not result in a change of economic position for the investor.

In that regard, two presentations given as part of the 15th Annual Effective Hedge Fund Tax Practices seminar, co-hosted by Financial Research Associates and the Hedge Fund Business Operations Association, covered the fundamentals of the taxation of swaps and the tax treatment of wash sales, constructive sales, short sales and straddles. This article, the fourth in our four-part series covering the seminar, summarizes the key takeaways from those presentations. Panelists for the session entitled "Taxation of Swaps, Commodities and Other Contracts" included Joseph T. Heavey, CPA, a principal at Rothstein Kass, and Eric C. Fox, a principal at Deloitte Tax LLP. George Michaels, founder and Chief Executive Officer of G2 FinTech, and E. George Teixeira, a partner at Anchin, Block & Anchin LLP, were the panelists for the session entitled "Wash Sales, Straddles, Short Sales, Constructive Sales and Other Potential Pitfalls."

The first article in this series covered three sessions addressing contribution and distribution of property to fund investors, allocation of investment gains and losses to fund investors and preparation of Forms K-1. See "Hedge Fund Tax Experts Discuss Allocations of Gains and Losses, Contributions to and Distributions of Property from a Fund, Expense Pass-Throughs and K-1 Preparation at FRA/HFBOA Seminar (Part One of Four)," The Hedge Fund Law Report, Vol. 7, No. 2 (Jan. 16, 2014). The second article discussed issues impacting foreign investors in foreign funds, including basics of withholding with respect to fixed or determinable annual or periodic gains, profits, or income (FDAPI); the portfolio interest exemption from FDAPI withholding; the pitfalls of effectively connected income (ECI) for offshore hedge funds; and the sources of ECI. See "Tax Experts Discuss Provisions Impacting Foreign Investors in Foreign Hedge Funds During FRA/HFBOA Seminar (Part Two of Four)," The Hedge Fund Law Report, Vol. 7, No. 3 (Jan. 23, 2014). The third article addressed taxation of foreign investments, including withholding at the source, rules regarding controlled foreign corporations and issues concerning taxation of distressed debt investments. See "Tax Practitioners Discuss Taxation of Foreign Investments and Distressed Debt Investments at FRA/HFBOA Seminar (Part Three of Four)," The Hedge Fund Law Report, Vol. 7, No. 4 (Jan. 30, 2014).

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Tax Treatment of Swaps

Mark-to-Market Taxation of Certain Swaps

Swaps that fall under Section 1256 of the Internal Revenue Code (IRC) are taxed at the close of each tax year on a mark-to-market basis. A panelist noted that, regardless of holding period, any gain or loss is deemed to be 60% long-term and 40% short-term. He explained that Section 1256 covers five types of swap contracts, of which three are relevant to hedge funds: Regulated futures contracts, foreign currency contracts and non-equity options. A regulated futures contract is one that trades on a regulated futures exchange. Such exchanges require margin from traders that is adjusted on a daily basis. He called this a "mini-realization event." Foreign currency contracts are contracts that trade off-exchange. In order to qualify for Section 1256 treatment, the currency must be a currency that is traded through regulated futures contracts. A non-equity option is any option that is not an equity option. Generally, equity options are options on individual stocks or narrow indexes. He noted that the rules give traders choices if they want a contract to be covered by Section 1256. For instance, an option on the S&P 500 index would be considered a non-equity option, while an option on an exchange traded fund (ETF) that mimics the S&P 500 would be an equity option because it is technically an option on the securities of the corporation that operates that ETF.

A panelist explained that three types of contracts are excluded from Section 1256: Securities futures contracts or options on such contracts; centrally-cleared swaps and derivatives; and hedges, a term that is broader than its common meaning. Fox explained that notional principal contracts (NPC) are governed by Treas. Reg. §1.446-3 and include payments determined with reference to a specified index that are paid at specified intervals with reference to a notional principal amount. Fox explained that a total return swap is a type of NPC that mimics economic ownership of the reference security. During the term of the swap, the "short" party pays to the "long" party an amount equal to all periodic dividend, interest or other payments generated by the reference security; the long party pays financing amounts to the short party based on a specified reference interest rate. At termination, there is a final payment based on any change in value of the reference security. The speakers noted that there is considerable controversy over the appropriate tax accounting method for contingent NPCs, such as total return swaps. Fox explained that most people who use total return swaps choose mark-to-market accounting for simplicity. See "District Court Holds that Long Party to Total Return Equity Swap May be Deemed to Have Beneficial Ownership of Hedge Shares Held by Swap Counterparty," The Hedge Fund Law Report, Vol. 1, No. 14 (Jun. 19, 2008) (section entitled "Total Return Equity Swaps").

Fox explained that, under an NPC, all payments other than a termination payment are ordinary income, regardless of whether the payments on the reference security would be afforded more favorable tax treatment. For instance, dividend equivalent payments are taxed as ordinary income at the highest marginal rate. A termination payment is treated as a short- or long-term capital gain or loss, depending on the actual term of the contract.

Fox explained that a "bullet" swap is similar to a forward contract that has a single payment at the time the contract is settled: Financing payments, actual (as opposed to estimated) dividend and interest payments on the underlying security, and a payment to reflect change in value of the reference

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security are all deferred until the termination of the bullet swap, at which time they are netted, and a single settlement payment is made. The entire payment is generally treated as capital gain or loss. Fox explained that periodic interest can be paid or received in respect of collateral or margin posted for a bullet swap. It is not considered part of the swap. He added that recent regulations have called into question the tax efficacy of bullet swaps: Because periodic payments are deferred, they may not technically qualify as NPCs, which require "more than one payment" during the contract term. He explained that under proposed regulations, deferred fixed dividend payments are deemed to have been paid during the-term of the contract, thereby keeping the contract within the NPC regime.

Treating the Long Party as Owner of the Reference Security

Heavey noted that the IRS may look at substance over form and treat a party as constructively owning the underlying equity in a swap. Fox explained that the IRS considers a number of factors in determining whether a swap should be treated as synthetic ownership or "something else," such as an agency relationship or a securities lending transaction. Those factors include: whether a fund sold the security to the counterparty at the outset of the swap or bought it at expiration of the swap; whether the security is regularly traded; whether a party holds the actual security as collateral; whether the long party has voting rights; and whether the swap provides leverage to the long party. Fox noted that fully-funded swaps (swaps that are 100% collateralized) raise serious tax issues, but that the credit-worthiness of the counterparty may be a proper justification for requiring a swap to be fully-funded at various moments in time. They are common in some foreign jurisdictions, especially in Asia. The IRS has targeted swaps used to avoid U.S. dividend withholding tax. See "New IRS Audit Guidelines Target Equity Swaps with Non-U.S. Counterparties," The Hedge Fund Law Report, Vol. 3, No. 3 (Jan. 20, 2010).

Fox noted that IRC Section 1260 is an anti-abuse section that prevents parties from using derivatives to recognize long-term capital gains on income from pass-through entities. It provides that a party may only recognize long-term capital gain to the extent that the party would have received long-term capital gain on the underlying asset.

Swaps Referencing Master Limited Partnerships

Fox explained that some investors use swaps to gain exposure to master limited partnerships (MLPs), which are publicly-traded limited partnerships, typically operating in the mining or oil and gas industries. They have attractive yields and, because of their large depreciation expenses and partnership structure, generate tax-deferred cash payments in early years; however, sale of an MLP interest results in recognition of ordinary income to the extent of recapture. Disadvantages of direct investments in MLPs include dealing with K-1s, tax reporting requirements in states where the MLPs operate, recognition of unrelated business taxable income (UBTI) by tax exempt investors, generation of ECI for non-resident fund investors and possible FIRPTA withholding.

To support favorable tax treatment of a swap that references an MLP, Fox explained that reference securities should be publicly traded. The swap should reference less than 5% of the public float, otherwise the swap itself may become a FIRPTA asset. He noted that there is some debate as to whether the FIRPTA 5% publicly-traded exception applies to swaps on MLPs. To avoid Section 1260 issues, the swap

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should be cash settled with a term of 365 days or less. He recommended avoiding MLPs with little liquidity and fully-funded swaps. Collateral on MLP swaps is usually less than 50% of notional value. See "Tax and Structuring Considerations for Funds Organized to Invest in Master Limited Partnerships," The Hedge Fund Law Report, Vol. 6, No. 30 (Aug. 1, 2013).

Credit Default Swaps

Heavey distinguished credit default swaps (CDS) from total return swaps: In a total return swap, the long party gets all of the upside and all of the downside. In contrast, in a CDS contract, the protection buyer only gets paid if a credit event occurs. If there is no credit event, the buyer loses only its premium payments. He explained that in 2004, the IRS asked for input from practitioners on how CDS should be taxed. The possibilities included treating them as NPCs, insurance, guarantees or a series of put options. Only NPC and option treatment were deemed acceptable, and those two approaches are now commonly used. Under the option approach, the protection buyer's payments are treated as option premiums, which are capitalized (not a current deduction). Payment on a credit event or termination of the CDS is then a capital event. Others treat them as NPCs. He said "it is really unclear what the right answer is." In 2011, the IRS issued proposed regulations (never finalized) that would treat a CDS as an NPC. He believes the IRS' trend is towards the mark-to-market regime.

Wash Sales, Constructive Sales, Short Sales and Straddles

Michaels observed that the rules governing wash sales, constructive sales, short sales and straddles are united by a single goal: They aim to keep a securities holder from generating tax benefits for itself without a true change in economic position. Put another way, the IRS seeks to keep investors from converting long-term capital losses into short-term losses, short-term gains into long-term capital gains or unrealized losses into recognized losses. See "What Critical Issues Must Hedge Fund Managers Understand to Inform Their Preparation of Schedules K-1 for Distribution to Their Investors?," The Hedge Fund Law Report, Vol. 6, No. 11 (Mar. 14, 2013); and "IRS 'Managed Funds Audit Team' Steps Up Audits of Hedge Funds and Hedge Fund Managers, and Investigations of Hedge Fund Tax Compliance Issues," The Hedge Fund Law Report, Vol. 2, No. 34 (Aug. 27, 2009).

Wash Sales

Adopted in 1921, the wash sale rules are the oldest of such rules and are set forth in Section 1091(a) of the IRC. Michaels explained that, in a wash sale, a holder sells a security in order to recognize a loss and immediately buys the same or a "substantially identical" security back for approximately the same price. The rule covers replacement securities acquired anywhere from 30 days before to 30 days after the sale in question. Michaels explained that if a holder executes a wash sale, the holder is not entitled to recognize the capital loss in the year of the sale. Instead, the loss is disallowed and added back to the basis of the replacement security. Consequently, the holder will get the benefit of the loss when the security is eventually sold.

Michaels noted that the-term "substantially identical" is not defined anywhere. He takes a "common sense" approach, asking: Are they "close enough for all practical purposes"? One IRS revenue ruling explored which particular properties, when different, are sufficient to prove two securities are not substantially identical. Another ruling found that several less significant differences between two securities, when viewed together, constituted a material difference. He noted that a security that was sold and replaced with a total return swap on the security might not be a wash sale if the swap did not include voting rights.

Michaels explained that "chaining" (a later wash sale in the same security) will not avoid the rule. In "branching," there is a mismatch between the number of shares sold and the number repurchased. If the holder only replaces half of the sold shares, the holder would be able to take half of the loss; conversely, if the holder bought twice the number of replacement shares, the loss would be disallowed and there would only be a basis adjustment with respect to half of the replacement shares.

Michaels added that if a holder sells a security and then purchases a forward contract or call option on the security (or purchases other securities with an embedded option), the wash sale rule is triggered. Finally, Section 1091 also applies to short sales, so a holder that sells a security short, covers a loss on the sale and then sells it short again is subject to the rule. Teixeira noted that a covered short sale followed by acquisition of a put on the stock may pass muster if the put expires more than 30 days after the short sale is covered. Practitioners are divided on the efficacy of that strategy. Teixeira added that disposing of an option and then buying the security is not a wash sale.

Constructive Sales

Teixeira noted that, while wash sale rules limit the loss that can be recognized, the constructive sale rules under IRC Section 1259 require a holder to recognize gain even if a security is not sold. He said the rules were adopted in response to a technique that allowed a shareholder to defer recognition of capital gains on a security by selling the security short and keeping the short position open (a "boxed" position). Michaels estimated that in the early 1990s, hedge funds had "parked" billions of dollars of capital gains in this way, completely legally. Teixeira noted that those positions were grandfathered in when Section 1259 was enacted.

Teixeira observed that a taxpayer must recognize gain upon entering into a constructive sale of an "appreciated financial position" in stock, partnership interests or nonconvertible debt, including options, short sales and futures with regard to those securities. Teixeira said that if Section 1259 applies, the holder must recognize gain on the date of the constructive sale as if the position were sold and immediately repurchased. The basis of the offsetting position is adjusted to reflect the gain that was recognized. Teixeira noted that a constructive sale may occur with regard to a number of different transactions, such as a long position or call option followed by an offsetting short, swap or forward sale; or a short position or put option followed by an offsetting long position. Some transactions, such as certain collars, or a long position offset by a "deep-in-the-money" put, fall into a gray area.

Teixeira noted that there are two exceptions to the constructive sale rules: First, he said that none of these rules apply to a mark-to-market fund. The second is for short-term hedges: A fund may hedge its positions throughout the year; it has until January 30 of the following year to decide whether to close an offsetting position and remain unhedged for 60 additional days.

In response to an audience question, Michaels and Teixeira explained that if a fund of funds elected to hedge an investment in a portfolio fund by shorting one of the positions held by that portfolio fund, it would most likely not result in a constructive sale. The answer would depend in part on the number of positions held by the portfolio fund. See "SEI Report Highlights Challenges Faced by Fund of Hedge Funds Industry and Recommends Improvements," The Hedge Fund Law Report, Vol. 5, No. 47 (Dec. 13, 2012).

Short Sales

Teixeira explained that short sales are governed by IRC Section 1233. Generally, the settlement date of the closing of a losing short position is the date on which a loss is recognized. A gain on an appreciated short position is recognized on the trade date. Under Section 1233, the holding period of the security used to cover the short governs whether gain or loss on the short is deemed to be short-term or long-term. He added that there are three rules under Section 1233 designed to prevent investors from converting short-term capital gains into long-term gains and long-term capital losses into short-term losses:

- If an investor closes out an appreciated short sale with a lot of shares held long-term, but also has a lot of such shares that have been held short-term, the gain on the closing of the short position will be deemed to be short-term.
- If an investor who owns sufficient shares to close out an appreciated short position closes out the short position with a newly-purchased (different) lot of shares, the holding period of the previously-owned shares will begin to run from the date of the closing of the short sale.
- If an investor who owns sufficient long-term shares to close out a losing short position closes out the short position with a newly-purchased (different) lot of shares, the loss is treated as a long-term capital loss.

Straddles

Michaels noted that straddles are covered in IRC Section 1092. The laws were introduced in the early 1980s in response to abusive tax shelters. In a straddle, an investor takes offsetting positions in two similar securities, knowing that one will have a gain and the other a loss. The investor closes out the losing position at the end of the tax year in order to generate a tax loss in that year. Michaels said the loss generated in a straddle is only deferred "to the extent that the [appreciated position] has a gain" as of the end of the tax year in which the loss was generated. Unlike losses that are deferred on wash sales, which are added to the basis of the replacement security, the deferred loss on a straddle is held "in limbo" until all the components of the straddle are eventually terminated. Michaels noted that there is an exception to the straddle rules for qualified covered calls (as defined in the applicable regulations).

Michaels stressed that cost basis adjustments may have impact on other sections of the IRC, a phenomenon he referred to as interweaving. As an example, he explained that a wash sale results in an increased cost basis of the replacement security. However, that appreciated security may no longer be considered an appreciated financial position for purposes of the constructive sale rules, which is a beneficial result. He cautioned that it is critical to consider the interplay of all of the applicable rules.