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Advanced Topics in Constructive Sales: The Exceptions*

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White Paper

Abstract: Section 1259 of the Internal Revenue Code (IRC) addresses the case where taxpayers try to defer capital gains by using short sales -- a practice known as "Short Vs. the Box." Embedded in section 1259 are the "Closed Transaction Exception" and the "Serial Hedge Exception," which in certain circumstances allow the taxpayer to avoid the constructive sale rule. The essence of these exceptions is that *temporary* hedges were not intended (by Congress) to trigger Constructive Gains as long as an adequate period of risk exposure exists following the hedge. This paper examines specific considerations on how to interpret and implement these exceptions. It also provides examples on how these exceptions interact with the straddle rule (1092), which involves offsetting positions.

By George Michaels

with William Fang

and Daniel Tilkin

* This white paper is a work in progress. We are currently requesting comments on its contents as we complete the final version of this paper. Please send your comments to jmichaels@g2ft.com. We look forward to hearing from you.

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Introduction

The constructive sale rule was introduced to the IRC in 1997 by the “Taxpayer Relief Act.” The rule was created to prevent the taxpayer from deferring capital gains tax obligations through the use of creative short-selling. The simplest instance of a constructive sale is when an investor, who has an appreciated financial position (AFP), opens a short against that position. For example, a share of ABC is purchased at $5; ABC appreciates to $8; and the investors shorts ABC at $8.

Although hedge fund managers and other sophisticated investors had been using short-selling to defer capital gains for decades, it was the Estée Lauder estate case that brought this practice to the public’s attention. As a result, section 1259 of the tax code was created to force individuals to recognize capital gains anytime their trading activity matches any one of a set of patterns the tax code defines as a “constructive sale.”

Definitions and Sources

Sources for the definition of a “constructive sale” include the IRC[1] and Revenue Rulings (RR). To help define what constitutes a constructive sale and other taxable events, the IRS periodically enhances the IRC with a series of revenue rulings on an as-needed basis to rule on specific cases that crop up based on section 1259 and other sections of the IRC. Revenue Ruling 2003-01 is thus far the only ruling that addresses exceptions to constructive sales, and as we shall see, is no longer relevant. However, more rulings may be added as the practice of constructive sales evolves.

The Working Families Tax Relief Act of 2004 made a textual change to section 1259. Section 1259(c)(3)(B) was originally titled "POSITIONS WHICH ARE REESTABLISHED." In 2004 it was changed to "CERTAIN CLOSED TRANSACTIONS WHERE RISK OF LOSS ON APPRECIATED FINANCIAL POSITION DIMINISHED.” The substance of 1259(c)(3)(B) was also modified. The original reference dealt with legs that would form a constructive sale, and the modified version expanded the scope to include legs that would result in a reduction in risk. The effect of this change was to render RR 2003-1 obsolete. In this paper we refer to the 1259(c)(3)(B) exception as the Serial Hedge Exception and 1259(c)(3)(A) as the Closed Transaction Exception.

The IRC also grants the IRS the statutory authority to implement the law. Under this authority, the IRS has the prerogative to make changes to or add to the Code of Federal Regulations (CFR). However, in the case of constructive sales, the IRS has not separately added text to the CFR.

Although all this documentation is critical, it is also important to remember that the U.S. judicial system always serves as the ultimate arbiter of the law. Legal precedent can therefore override any of the above documents with regard to constructive sales. At the moment, we are not aware of any court rulings that affect Constructive Sales.

A collection of laws, regulations and rulings define and explain what constitutes a constructive sale. This paper explores certain advanced topics that are implied by the wording of USC Title 26 Section 1259(c)(3), the text of the USC that governs a constructive sale. It is not an exhaustive exploration but it does cover many of the critical elements that practitioners should consider when trying to determine the application of the laws relevant to accurately calculating capital gains.

[1] The Internal Revenue Code is Title 26 of the United States Code (USC)

[Note: This paper is intended for readers with a working knowledge of section 1259. For a primer or refresher on section 1259, please see our paper "Constructive Sales."]

Section 1: Exceptions to Constructive Sales

Section 1259 allows for two exceptions by which a taxpayer can avoid constructive sales. They are often called the Closed Transaction Exception and the Serial Hedge Exception. These exceptions are difficult to work with and are made even more complex because they interact with the wash sale rules.

It is open to speculation as to exactly why these exceptions were created. The following "hedging" scenario could be considered one feasible reason. In this scenario, a taxpayer might wish to temporarily hedge their downside in a position, which under normal conditions might be considered 'safe' or 'wise.' For example, a taxpayer might be aware that earnings are to be announced for a company in which they hold a major stake. They feel that should the earnings announcement result in a disaster, they might lose much more value in their position than under normal market variations. Therefore, for the few days up to the announcement, they hold a short (hedging) position. As soon as earnings are announced (but no disaster occurs) they close the short and go back to having a normal long (unhedged) position. The code permits that as long as they continue to hold the original position unhedged for 60 days after the short then no constructive sale has occurred. The Serial Hedge Exception simply extends the basic exception to cover cases where a series of hedges are executed over time. Our conclusion is that *temporary* hedges were not intended (by Congress) to trigger Constructive Gains if there was a sufficient period of risk exposure following the hedge.

Section 1A: Closed Transaction Exception

Section 1259(c)(3)(A) describes the Closed Transaction Exception, which allows the taxpayer to avoid recognizing a constructive sale provided three criteria are satisfied:

(i) Leg-2 is closed before the 30th day following the end of the tax year.
(ii) The taxpayer continues to hold Leg-1 for 60 days after Leg-2 is closed.
(iii) Leg-1 does not have its risk of loss reduced during the 60-day period.

This exception is relatively straightforward. In economic terms, it means a taxpayer can avoid a constructive sale if his Leg-1 is exposed for at least 60 days after closing Leg-2.

Example 1

Activity

The taxpayer carries out the following trades. This taxpayer uses calendar year as tax year.

2012/07/01 Lot A buy 1 share XYZ @ cost $10
2012/10/16 Lot B short 1 share XYZ @ cost $16
2012/12/15 Cover Lot B at no gain or loss
No more trades on XYZ until 2013/04/01

Result

For tax year 2012, the taxpayer is exempt from the constructive sale that Lot A and Lot B could have formed:

(i) He closes Leg-2 before the 30th day following the end of the tax year. He could have closed this leg as late as January 30, 2012.

(ii) The taxpayer holds Leg-1 for 60 days following the cover of Lot B.

(iii) Risk of loss for Leg-1 is never reduced during the 60-day period in (ii).

The following examples illustrate how the exception does not hold. Assume the taxpayer uses calendar year as tax year.

Example 2

Activity

2012/07/01 Lot A buy 1 share XYZ @ cost $10
2012/10/16 Lot B short 1 share XYZ @ cost $16
2013/01/31 Cover Lot B at no gain or loss
No more trades until 2013/04/01

Result

Taxpayer does not close Lot B before the 30 days after tax year end and therefore fails 1259(c)(3)(A)(i).

Example 3

Activity

2012/07/01 Lot A buy 1 share XYZ @ cost $10
2012/10/16 Lot B short 1 share XYZ @ cost $16
2012/12/15 Cover Lot B at no gain or loss
2013/01/31 Sell Lot A @ $17
No more trades until 2013/04/01

Result

Taxpayer does not hold Lot A for 60 days after closing Lot B and therefore fails 1259(c)(3)(A)(ii).

Example 4

Activity

2012/07/01 Lot A buy 100 share XYZ @ cost $10
2012/10/16 Lot B short 100 share XYZ @ cost $16
2012/12/15 Cover Lot B at no gain or loss
2013/01/16 Lot C long 1 put option on 100 shares XYZ @ $9 strike expiring on 2013/06/01
No more trades until 2013/04/01

Result

Taxpayer fails 1259(c)(3)(A)(iii) by reducing the risk of Lot A during the 60-day period.

Example 5

Activity

2012/07/01 Lot A buy 100 share XYZ @ cost $10
2012/10/16 Lot B short 100 share XYZ @ cost $16
2012/12/15 Cover Lot B at no gain or loss
2013/01/16 Lot C short 30 shares XYZ @ $9
No more trades until 2013/04/01

Result

Taxpayer fails 1259(c)(3)(A)(iii) by reducing the risk of Lot A during the 60-day period. But in this case, only 30 shares in Lot A are subject to a constructive sale gain of $6 a share while the other 70 shares are not.

Section 1B: Serial Hedge Exception

Section 1259(c)(3)(B) describes the Serial Hedge Exception, which expands the scope of the Closed Transaction Exception. It allows a taxpayer to avoid a constructive sale even if he violates 1259(c)(3)(A)(iii) -- the risk reduction part of the test. The taxpayer may accomplish this if the risk reduction transaction is closed and all the rules that applied to Leg-2 in the Closed Transaction Exception also apply to the risk reduction transaction.

Specifically, the criteria are:

1) This risk reduction position is closed before the 30th day following the end of the tax year.

2) Leg-1 continues to remain open for 60 days after the risk reduction position is closed.
3) No new risk reduction transaction occurs during the 60 days unless it also meets these criteria.

This exception is recursive in nature. However, it does not cause an infinite loop since all replacements on the original leg must ultimately end by the 30th day following the end of the tax year. In economic terms, it means a taxpayer can repeatedly enter into short-term hedges on his Leg-1 and still avoid a constructive sale if his Leg-1 is ultimately exposed for at least 60 days.

Example 6

Activity

The taxpayer carries out the following trades. This taxpayer uses calendar year as tax year.
2012/07/01 Lot A buy 1 share XYZ @ cost $10
2012/10/16 Lot B short 1 share XYZ @ cost $12
2012/12/15 Cover Lot B at no gain or loss
2013/01/05 Lot C short 1 share XYZ @ cost $14
2013/01/29 Cover Lot C at no gain or loss
Assume no more trades on XYZ until 2013/04/01

Result

For tax year 2012, the taxpayer is exempt from the various constructive sales that Lot A could have formed. Lot B does not trigger a constructive sale if any of the following are true:

(i) Lot B is closed before the 30th day following the end of the tax year (January 30, 2013, in this example).
(ii) Lot A is held for 60 days after Lot B was closed.
(iii) Lot C does serve to reduce the risk of Lot-A during the 60-day window. However, Lot C may be ignored for this purpose since it meets the following criteria:
   (iii-a) Lot C is itself closed before the 30th day following the end of the tax year.
   (iii-b) Lot A is held for 60 days after lot C was closed.
   (iii-c) Lot A experiences no further reductions in risk during that 60-day period.

Conclusion: Since Lot C is exempted from being considered a reduction in risk, Lot B is exempted from a constructive sale.

Section 2: When an Exception Fails

When a position is exempted from a constructive sale due to Closed Transaction or Serial Hedge Exceptions, it can still subsequently form a constructive sale if the exception ultimately fails. In addition, a position can be constructively sold multiple times when a potential Serial Hedge Exception fails. However, each constructive sale does raise the cost basis of the original position.

Example 7

Activity

This taxpayer uses calendar year as tax year.
2012/02/05 Lot A buy 1 share XYZ @ $10
2012/04/30 Lot B short 1 share XYZ @ $16
2012/05/01 Cover Lot B @ $19, for a loss of $3
2012/06/25 Lot C short 1 share XYZ @ $17
2012/07/12 Cover Lot C @ $17, for no gain or loss
2013/01/29 Lot D long 1 put option on 1 share XYZ @ $9 strike expiring on 2013/6/01
No more trades on XYZ till 2013/04/01

Result

The taxpayer seemingly could have avoided any constructive sale after he closes Lot C. However, Lot D fails the Serial Hedge Exception and all preceding constructive sales that might have been avoided now apply. So for the tax year 2012, the taxpayer has two constructive sales. The first constructive sale occurs on 2012/04/30 with Lots A and B, for which the taxpayer recognizes a $6 gain and adjusts Lot A's basis to $16 and date to 2012/04/30. The second constructive sale occurs on 2012/06/25 with Lot C, for which the taxpayer recognizes a $1 gain and adjusts Lot A's basis to $17 and date to 2012/06/25. A total of $7 is recognized.

Let us point out a few interesting observations:

The $3 loss incurred in closing Lot B does not affect the constructive sale. However, this $3 loss may be disallowed due to the Straddle rule. See section 8, "Interweaving Constructive Sales with Straddles."

Lot C forms a constructive sale with Lot A whose cost basis was previously adjusted to $16, thus resulting in only an incremental $1 gain.

Lot B was closed, but it still contributes to a constructive sale. From a gain point of view, whether a single constructive sale of A-C is formed or two constructive sales of A-B and A-C are formed, the total gain is $7. However, since the timing of the recognition *and* the holding periods are affected, it is very important not to lump the various constructive sales into one.

Section 3: Risk Reduction or a New Constructive Sale?

Suppose the taxpayer has multiple long lots -- each holding 1 share of XYZ. He then shorts 1 share of XYZ at a point when all the open long lots are AFPs. He then covers the short; and within 60 days, he opens another short. Does the second short violate 1259(c)(3)(A)(iii) and therefore count as reducing the risk of the first constructive sale and therefore extend the first constructive sale? Or can the second short be used for creating a new constructive sale and therefore be irrelevant for purposes of the Serial Hedge Exception?

The answer is that both events occur. The position has been re-hedged for the original constructive sale and therefore the Closed Transaction Exception has been violated. It follows that the original constructive sale is open (for consideration) once again. However, the new short sale can be paired against any of the available AFPs as per the taxpayer's retirement method (First In First Out (FIFO) etc.). Also note that the increased cost basis due to the original short may cause the affected lot to no longer be eligible as Leg-1 in the new constructive sale due to its adjusted cost basis being higher than the price at the time of the new short sale.

Note: A strict reading of 1259 would dictate that *all* constructive sales that are candidates for the Closed Transaction or Serial Hedge Exception would have their "clocks reset" by any position that could be construed as reducing risk of the original Leg-1. Common practice is to limit this to on a share-count basis; but this approach is not technically required. See section 5 "Order Dependence in Serial Hedge Exception," for a deeper dive.

Example 8

Activity

This taxpayer uses calendar year as tax year. Assume taxpayer uses specific lot identification to retire open lots.
2012/07/01 Lot A buy 1 share XYZ @ cost $10
2012/08/01 Lot B buy 1 share XYZ @ cost $13
2012/09/01 Lot C buy 1 share XYZ @ cost $14

2012/10/16 Lot D short 1 share XYZ @ cost $15
(taxpayer chooses Lot C for constructive sale)
2012/12/15 Cover Lot D at no gain or loss
2012/12/20 Lot E short 1 share XYZ @ cost $16
(taxpayer chooses Lot A for constructive sale)
No more trades on XYZ until 2013/05/01

Result

Lot E causes the closed transaction exception (1259(c)(3)(A)(iii)) to fail for the C-D constructive sale. The taxpayer may choose any of lots A, B or C for a constructive sale with Lot E, and the taxpayer chooses A. But even with the choice of Lot A to form a constructive sale, the taxpayer has still failed section 1259(c)(3)(A)(iii) for the original C-D constructive sale. Thus the taxpayer must recognize gains from both constructive sales, with a $1 in gain from the C-D constructive sale and $6 gain from the A-E constructive for a total of $7 in gain.

Section 4: Effects of Prior Event Adjustments on Lot Retirement

A basis adjustment due to a prior constructive sale (or similar event that triggers a basis adjustment) can lead to a number of consequences. This section discusses two of these consequences. First we will see how prior adjustments determine which lots are *actually* retired. Then we will consider the effects on the lots that are *constructively* retired. It is important to understand these consequences in order to better comprehend the issues in section 7 "Apparent Retroactivity and Circularity."

According to the regulations, the default algorithm for lot retirement (and constructive lot retirement) is FIFO. This means when multiple choices are available, the "oldest" of available tax lots is selected for disposition. The constructive sale rule adjusts the holding period of lots that have been constructively sold. One could reasonably consider the argument that constructive sales affect only the holding period for determination of long-term or short-term gains, but *do not* affect the acquisition date and therefore *do not* affect FIFO (or other algorithms). One could also argue the reverse -- which is that constructive sales *do* affect the acquisition date and can therefore affect which lots might be selected for retirement (or constructive retirement) with FIFO. The following examples compare both treatments.

First, let's consider the case of simple lot retirement.

Example 9

Activity

This taxpayer uses calendar year as tax year.
Assume we use FIFO based on the *adjusted* date.
2012/07/01 Lot A buy 1 share XYZ @ cost $10
2012/08/01 Lot B buy 1 share XYZ @ cost $13
2012/10/16 Lot D short 1 share XYZ @ cost $16
2012/12/20 Sell 1 share XYZ @ cost $12
No more trades on XYZ until 2013/05/01

Result with Unadjusted Constructive Retirement

On 10/16, Lot A is the first-in and therefore forms a constructive sale with Lot D. Thus the taxpayer recognizes a $6 gain due to the constructive sale and Lot A now has an adjusted cost basis of $16 and uses the date of 2012/10/16 for the purpose of determining holding period only. On 12/20, Lot A is still to be considered the first-in (its acquisition date is 07/01/12), so Lot A is sold for a loss of $4 (the lot has an adjusted basis of $10 + $6 and sold for $12).

Result with Adjusted Constructive Retirement

On 10/16, Lot A is the first-in and therefore forms a constructive sale with Lot D. Thus the taxpayer recognizes a $6 gain due to the constructive sale and Lot A now has an adjusted cost basis of $16 and a date of 2012/10/16. On 12/20, Lot B can be considered the first-in (its acquisition date is 08/01/12), so Lot B is sold for a loss of $1.

Both interpretations are acceptable, although a taxpayer should consistently use one approach. However, once you involve the Closed Transaction Exception you create a new wrinkle that we examine in section 6 “Correctly Processing the Exception Rules.”

Now, let us consider a case involving *constructive* lot disposition.

Example 10

Activity

This taxpayer uses calendar year as tax year. Assume taxpayer uses (unadjusted) FIFO to retire open lots.
2012/07/01 Lot A buy 1 share XYZ @ cost $10
2012/08/01 Lot B buy 1 share XYZ @ cost $13
2012/09/01 Lot C buy 1 share XYZ @ cost $14
2012/10/16 Lot D short 1 share XYZ @ cost $16 (forms a constructive sale with A)
2012/12/15 Cover Lot D at no gain or loss
2012/12/20 Lot E short 1 share XYZ @ cost $17 (forms a constructive sale with B)
No more trades on XYZ until 2013/05/01

Result with Unadjusted Constructive Retirement

Lot A, the first-in, and Lot D form a constructive sale, adjusting Lot A's cost basis to $16, while recognizing a short-term gain of $6. For the purpose of holding period only, Lot A's date is adjusted to 2012/10/16. Lot D is then closed, but Lot E causes 1259(c)(3)(A)(iii) not to be met; therefore the A-D constructive sale does not qualify for the Closed Transaction Exception. It also fails to qualify for the Serial Hedge Exception, because E is not covered by January 30th of 2013.

E is paired with A because we assume that A’s acquisition date has remained as 2012/07/01. At the end of the year, when we determine the A-D will *not* be exempted, we raise the cost basis of A to $16, making the A-E constructive sale show only $1 of gain. If it were the case that A’s cost basis were raised to the point that it was no longer AFP, we would need to re-consider other pairings with E, but we will leave that exploration to section 6 “Correctly Processing the Exception Rules.”

Result with Adjusted Constructive Retirement

The A-D constructive sale behaves the same as in the unadjusted case, but the short E behaves differently. When the short of E occurs, it is paired with Lot B, because we assume that Lot-A now has a date of 2012/10/16 so it is no longer the first in. The B-E constructive sale generates an additional gain of $4.

Section 5: Order Dependence in Serial Hedge Exception

In wash sale analysis, the replacement can occur before the disposition. For example, the series of Buy @ $10 - Buy @ $4 - Sell @ $5 (the $10 shares within 30 days) triggers a wash sale in the same way Buy @ $10 - Sell @ $5 - Buy @ $4 (within 30 days) does. In other words, the replacement and the disposition are order-independent as long as they fall within the 30-day window. Does such an order-independence apply to the Closed Transaction Exception rule?

In all of the examples we have looked at so far, the transaction that reduces the risk of loss has happened after the closing of Leg-2. But what happens if the risk-reducing transaction was already in place at the time Leg-2 is closed? A situation where the risk-reduction transaction occurs before the closing of Leg-2 still fails the Closed Transaction

Exception. This is because a simple literal reading of 1259 makes no reference to the timing of the risk-reducing transaction. It simply states "at no time during the 60-day period is the taxpayer's risk of loss ... reduced..."

Example 11

Activity

This taxpayer uses calendar year as tax year.
2012/03/05 Lot A buy 1 share XYZ @ $14
2012/03/06 Lot B short 1 share XYZ @ $16
2013/01/06 Lot C short 1 share XYZ @ $16
2013/01/07 Cover Lot B @ $15

Result

Lot B forms a constructive sale with Lot A. The Closed Transaction Exception does not apply. Parts (i) and (ii) are satisfied. Part (iii) is not satisfied because Lot C reduces the taxpayer's risk of loss during the 60-day period beginning when Lot B is closed on 2013/01/07.

This example makes it clear that allowing the risk-reducing transaction to be entered into before Leg-2 is closed is important. If that were not allowed, entering into a new short and then closing the existing short could be repeated indefinitely, deferring recognition of the constructive sale indefinitely.

However, what happens when this risk-reducing transaction is closed? Can we then qualify for the Serial Hedge Exception? Surprisingly, a literal reading of the tax code says that the answer is no! 1259(c)(3)(B)(ii) describes the case where: "(ii) another transaction is entered into during the 60-day period beginning on the date the transaction referred to in clause (i) is closed—" It is only in this situation that the transaction can be ignored. But if the risk-reducing transaction was entered into BEFORE said 60-day period, there is no provision for ignoring it. Thus the original transaction is still a constructive sale.

Example 12

Activity

This taxpayer uses calendar year as tax year.
2012/01/05 Lot A buy 1 share XYZ @ $14
2012/01/06 Lot B short 1 share XYZ @ $16
2012/04/06 Lot C short 1 share XYZ @ $16
2012/04/07 Cover Lot B @ $15
2012/07/05 Cover Lot C @ $15

Result

According to a literal reading of the tax code, Lot B forms a constructive sale with Lot A. Lot C causes the Closed Transaction Exception not to apply, because it reduces the risk of loss from Lot A during the 60-day period starting on 2012/04/07. However, since Lot C was not "entered into" during that 60-day period, the Serial Hedge Exception does not allow for it to be ignored.

Frankly, this result seems strange. Since Lot A is held unhedged for more than 60 days, it seems like the intent would be to exempt this from forming a constructive sale. It is possible that this was a deliberate decision by the writers of this section of the tax code; however the reason for this (such as closing a further loophole) is not obvious to the authors. An aggressive approach would be the following: Expand the Serial Hedge Exception to allow for any risk-reduction position that invalidates the Closed Transaction Exception from being eligible for being closed.

Revenue Ruling 2003-1 addressed a similar situation. At the time, the version of the serial hedge exception only provided for disregarding a transaction if it "would otherwise be treated as a constructive sale of such position." Revenue Ruling 2003-1 clarified that a risk-reducing transaction "[did] not require that the subsequent transaction independently would cause a constructive sale based on appreciation in the position at the time the subsequent transaction occurs." Part of the justification for this was that "Nothing in the statute or legislative history indicates that Congress intended this dissimilar treatment" for taxpayers in similar situations. This was then codified into law via the "Working Families Tax Relief Act of 2004." It is possible that the IRS will make a similar allowance here, that the spirit of the law is to allow these positions to be ignored as long as they meet 1259(c)(3)(B)(i)-(iii), even if they were not "entered into during the 60-day period beginning on the date [Leg 2] was closed."

Section 6: Correctly Processing the Exception Rules

The exception rules require a 60-day waiting period before it becomes clear whether a given constructive sale qualifies for exemption. Unfortunately, during that 60-day period, decisions may be required that rely on this information. As we discussed in section 4 "Effects of Prior Event Adjustments on Lot Retirement," an obvious concern is how *potential* constructive sales impact both lot retirement and constructive lot retirement. One example of this is whether a lot is even an AFP depends on whether it was previously constructively sold.

To avoid having to make decisions that might later become impossible (such as constructively selling a position that is not an AFP), the authors strongly advise not making such decisions until all pertinent information is available. This can be done in one of two ways. The simpler option is the taxpayer waits until 90 days following the end of the tax year (typically March 1st) and then and only then performs the constructive sale analysis. The more complex option is to consider each potential constructive sale independently and only process them once one is 100% sure that that particular constructive sale has failed or passed the exception rules. This is much more complex than the simple "wait until the year is over" approach and offers little in terms of added value, but we touch on some of this in section 7 "Apparent Retroactivity and Circularity."

If the taxpayer waits until the end of the year to process each constructive sale sequentially, then any trickle-down effects of this constructive sale are *known* and not guessed. This avoids apparent retroactivity and backtracking, which will be discussed further in section 7.

Assuming the taxpayer is going to wait until the end of the year to determine which constructive sales are exempted, the following obvious quandary remains: can they comply with the regulatory requirement that dictates that constructive dispositions must be decided by settlement date? The solution is to consider all potential constructive sales every time a new lot opened.

For any trade that might result in a constructive disposition, the taxpayer creates a *priority queue* of all open lots that could potentially be AFPs and could be constructively disposed of at the time the *potential* constructive sale settles. A priority queue is the manifestation of a taxpayer's standing lot retirement instruction (e.g., FIFO, LIFO). With each iteration of the constructive sale analysis, the taxpayer traverses his priority to find the next potential pair of constructive sales. We illustrate this in the following example.

Example 13

Activity

This taxpayer uses calendar year as tax year.
2012/09/05 Lot A buy 1 share XYZ @ $10
2012/09/06 Lot B buy 1 share XYZ @ $11
2012/09/07 Lot C short 1 share XYZ @ $13
2012/10/06 Cover Lot C at no gain or loss
2012/11/01 Lot D short XYZ @ $14
No more trades until 04/01/2013

Result with Unadjusted Constructive Retirement

On 09/07, we see a short sale C. Because both lots A and B are AFPs with respect to lot C's trade price, we have a potential constructive sale. Since we are using FIFO, our most likely candidate for the constructive sale is Lot A. Our priority queue starts with A-C followed by B-C.

On 11/01 when the second short D occurs, we cannot know whether the original constructive sale engendered by C will hold or not. But because we are operating on an *unadjusted* basis, Lot A remains the first in, so we will drop A-D into the priority queue first. We then drop B-D into the queue with a *lower* priority. Queue: A-C, B-C, A-D, B-D

At the end of the year, we determine that A-C and B-C are both exempt due to the Closed Transaction Exception. We then consider the D-short. A-D is the first item in the priority queue that matches up to D. Since neither exception rule applies, the A-D constructive sale is upheld for a recognized gain of $4.

Result with Adjusted Constructive Retirement

On 09/07 the same event occurs. But on 11/01, if we presume the A-C would hold, adjusting A's acquisition date from 09/05 to 09/07, then B-D has higher priority, since B would appear older than A. The priority of A-D and B-D would be switched. Queue: A-C, B-C, B-D, A-D

At the end of the year, our analysis is similar to the previous case, except, the B-D constructive sale would be selected for a recognized gain of $3.

Section 7: Apparent Retroactivity and Circularity

Warning: This section is fairly complex. Also, it is only relevant if the practitioner wishes to pair up their constructive sales as they *potentially* occur without using a priority queue. If instead the practitioner simply lays down the algorithm by which legs are selected or uses a priority queue and waits until all prior constructive sales are resolved to do the actual leg selection, then this section may be considered optional reading.

For the above reason, the authors recommend that practitioners process constructive sales only after all pertinent information is available. This can be done in two ways: by waiting until either 90 days after the end of the tax year, when each specific constructive sale can be definitively processed for the Closed Transaction Exception or Serial Hedge Exception, or when the constructively sold lot is actually closed. However, we do understand that taxpayers who wish to fully optimize the taxation of their portfolios might wish to do "on-the-fly" analyses and this section takes a close look at what this entails.

What can *falsely* create confusion is the idea that once a constructive sale is fully resolved, that this in turn can alter historical tax lot retirement decisions. If this were permitted (it is not), then it would be possible to change the very conditions that created the constructive sale in the first place thereby creating circular loops. This is an incorrect approach to this problem.

The correct approach is to recognize that the retroactivity is merely *apparent*. Apparent retroactivity occurs due to making *incorrect* assumptions as to whether prior constructive sales were exempt or not. Once you discover that an assumption was made incorrectly, you must go back to the point in time that the incorrect choice was made and re-evaluate alternative choices. A simple case of this might be the decision to use one particular lot as a leg-1 for a constructive sale that later is no longer an AFP and you must unwind all work based on this faulty assumption. We call this *apparent* retroactivity because you could have avoided this re-evaluation if you simply waited until year end. In other words, it looks like you have to go backward because you chose to go forward when you didn't have enough information to do so yet.

As we stated in section 4, "Effects of Prior Adjustments on Lot Retirement," the taxpayer may elect to use the adjusted acquisition date when making retirement decisions. In any case, should resolution of *earlier* constructive sales make the taxpayer's later choices invalid or nonsensical, then the taxpayer *must* identify an alternative constructive sale (should one exist) once the original selection is known to be invalid. Again, remember that this ordering must be based only on information known at the time.

The taxpayer can make use of the priority queue we describe in section 6 "Correctly Processing the Exception Rules." By doing so, the taxpayer would have already identified an ordered list of potential leg-1 lots every time a prospective leg-2 was executed. Then, at the end of the year, the taxpayer goes down this list to select the first item that qualifies as a legitimate constructive sale (i.e. is an AFP at the time of the constructive sale and is not exempted). The authors believe that this mechanism represents the closest the taxpayer can come to total compliance with 1259.

Example 14

Activity

This taxpayer uses calendar year as tax year. Assume unadjusted FIFO for pairing.
2012/09/05 Lot A buy 1 share XYZ @ $10
2012/09/06 Lot B short 1 share XYZ @$13
2012/10/06 Cover Lot B at no gain or loss
2012/11/02 Lot C short XYZ @ $12
No more trades until 04/01/2013

Result

A-B is a constructive sale that adjusts the cost basis of A from $10 to $13. At the point C is entered into, if we assume A-B will be exempted and the cost basis of A will remain at $10, we would consider A-C to be a *potential* constructive sale. But by April 1, 2013, it turns out that A-B is not exempted. Thus the cost basis of A is raised to $13 and the A-C constructive sale does not occur because A is not an AFP at the time C is executed.

Example 15 Like the previous, except with an additional buy (Lot D) inserted

Activity

This taxpayer uses calendar year as tax year. Assume unadjusted FIFO for pairing.
2012/09/05 Lot A buy 1 share XYZ @ $10
2012/09/06 Lot B short 1 share XYZ @ $13
2012/10/06 Cover Lot B at no gain or loss
2012/11/01 Lot D buy 1 share XYZ @ $11
2012/11/02 Lot C short 1 share XYZ @ $12
No more trades until 4/01/2013

Result

As described in the previous example, by April 1, 2013, it turns out that A-B is not exempted. Thus the cost basis of A is raised to $13 and the A-C constructive sale does not occur because A is not an AFP at the time C is executed. Therefore, we instead select D to be constructively sold by C, even though we had anticipated A-C to be the pairing. The final result is two constructive sales, A-B and C-D for $3 and $1 gains respectively.

The *apparent* retroactivity is due to our incorrect assumption of A-C to be a potential constructive sale. Once we learn that A-B has held, we seemingly need to go back and reselect a new leg-1 for partnership with C. Had we simply waited until the end of the year to process constructive sales we would never have considered A-C in the first place. Hence we caused an unnecessary headache for ourselves.

Example 16 A constructive sale immune to exceptions

Activity

This taxpayer uses calendar year as tax year. Assume adjusted FIFO for pairing.
2011/04/01 Lot A Buy 1 share XYZ @ $10
2011/04/02 Lot B Short 1 share XYZ @ $13
2011/04/03 Cover B at no gain or loss
2011/04/04 Lot C Short 1 share XYZ @ $14
<60 days transpire>
2011/08/01 Lot D Short 1 share XYZ @ $12
2011/08/04 Cover D at no gain or loss
2011/08/05 Cover C at no gain or loss
No more trades until 04/01/2012

Result

The A-B potential constructive sale appears to fail the Closed Transaction Exception due to the appearance of C less than 60 days after B is closed. In fact A-C is another potential constructive sale. So when the D short appears, it seems the cost basis of A has been elevated to at least $13, rendering the A-D constructive sale impossible. Later on, when C is covered, the Serial Hedge Exception allows the A-B constructive sale to be exempted. Because A-B never happened, this means when we reconsider A-D, the cost basis of A is now back to $10, making A-D a constructive sale (with a gain of $2).

But things get a bit messy when D is covered. At first glance, the reader might see the A-D constructive sale as qualifying for the Closed Transaction Exception because D was closed and then no further risk reduction was performed for 60 days. However, remember from section 5 “Order Dependence in Serial Hedge Exception” that the risk reducing transaction can occur prior to the open of leg-2. This in fact has happened because C was already active when D was opened. Therefore risk was reduced at the moment of the open D transaction and the Closed Transaction Exception fails. So the reader might then ask why the later closure of C doesn’t qualify for the Serial Hedge Exception. It doesn’t because in order to qualify, the risk reducing trade must be entered during the 60-day period starting on or after the open of D. Since C was entered into before this window, the A-D constructive sale is permanently immune from either the Closed Transaction or the Serial Hedge Exception.

If the taxpayer wished to take the more aggressive approach as suggested at the end of section 5, this example would resolve very differently as the A-D constructive sale would also be exempted.

Example 17 Like the previous, with an additional purchase of Lot E

Activity

This taxpayer uses calendar year as tax year. Assume adjusted FIFO for pairing.
2011/04/01 Lot A Buy 1 share XYZ at $10
2011/04/02 Lot B Short 1 share XYZ at $13
2011/04/03 Cover B at no gain or loss

2011/04/04 Lot C Short 1 share XYZ at $14
<60 days transpire>
2011/08/01 Lot D Short 1 share XYZ at $12
2011/08/03 Lot E Buy 1 share XYZ at $10
2011/08/04 Cover D at no gain or loss
2011/08/05 Cover C at no gain or loss
No more trades until 4/01/2012

Result

The A-B (CS-1) constructive sale appears to hold because of the appearance of C less than 60 days after the close of B voids the Closed Transaction Exception. In fact A-C (CS-2) forms a second potential constructive sale. When Lot D occurs, A-D (CS-3) is not a potential constructive sale because A's cost basis is adjusted to at least $13. When Lot E occurs, D-E (CS-4) forms a potential constructive sale. Note that C-E is not considered a potential constructive sale at this moment because C is already serving as leg-2 in the A-C potential constructive sale that we are assuming will succeed.

When C is covered, the entire A-B-C combination (CS-1 and CS-2) is disregarded through the Serial Hedge Exception. That means A-D (CS-3) now does form a constructive sale. Because Leg D is consumed by A-D (CS-3), D-E (CS-4) is no longer a constructive sale. So Leg E forms a constructive sale with C (CS-5) for a gain of $4. Lastly, the cost basis of C is increased by the $4 gain of CS-5, so the cover of C now results in a loss of $4.

Once again, A-D cannot take advantage of the Serial Hedge Exception despite the fact that D was covered because the C short (risk reduction) occurred before the cover of D.

Example 18 Illustrates apparent retroactivity

Activity

This taxpayer uses calendar year as tax year. Assume taxpayer uses adjusted FIFO for pairing.
2012/07/01 Lot A buy 1 share XYZ @ $10
2012/08/01 Lot B Buy 1 share XYZ @ $13
2012/10/16 Lot D short 1 share XYZ @ $16
2012/11/15 Cover Lot D at no gain or loss
2012/12/20 Sell 1 share XYZ @ $12
No more trades on XYZ until 2013/05/01

Result

Let us first start with an *INCORRECT* resolution. You may have to read the text that follows a few times to in order to fully understand it!

On 10/16, Lot A is the first-in and therefore forms a constructive sale with Lot D. Thus the taxpayer recognizes a $6 gain and Lot A has a date of 2012/10/16 and an adjusted cost basis of $16. On 12/20, Lot B is the first-in, so Lot B is sold. But if Lot B were sold and D were covered and no more trades were done, that means Lot A couldn't be in a constructive sale because of the Closed Transaction Exception (Lot D was closed and Lot A was subsequently held with unmitigated risk of loss, since the 12/20 sale didn't affect Lot A). Therefore, the constructive sale should have been on Lot B. This means Lot A's date is never adjusted and Lot A should be sold based on FIFO, which means Lot B can't be in a constructive sale. Therefore, the constructive sale should have been on Lot A…so on and so forth.

Here is a *CORRECT* resolution using "on-the-fly" analyses.

When Lot D is shorted, both A-D and B-D are in our priority queue. Because Lot A is the older lot, it forms a *potential* constructive sale with Lot D, which adjusts its cost basis and acquisition date. On 12/20, Lot B is now "first-in" and is therefore selected to be sold for a loss of $1.

At the end of the year, we determine that A-D becomes exempt from the constructive sale rule due to the Closed Transaction Exception. At this point we *must* go down the priority queue and consider whether B-D might be a constructive sale, which it in fact is. Thus the taxpayer recognizes a gain of $3 for the B-D constructive sale, and may *legitimately* recognize a $4 loss for the actual sale of Lot B on 12/20 at a price of $12.

The taxpayer *may not* modify which lot was sold on 12/20. The regulations prohibit post settlement re-retirement. The later arrival of new events or information does not change this simple rule.

Section 8: Interweaving Constructive Sales with Straddles

The Closed Transaction Exception and the Serial Hedge Exception can generate a series of straddles as the taxpayer closes a series of short-term hedges.

Example 19

Activity

This taxpayer uses calendar year as tax year.
2011/01/05 Lot A buy 1 share XYZ @ $10
2011/03/02 Lot B short 1 share XYZ @ $14
2011/04/30 Cover Lot B at a loss of $1
2011/05/30 Lot C short 1 share XYZ @ $16
2011/07/01 Cover Lot C at a loss of $3
2011/08/25 Lot D short 1 share XYZ @ $17
No more trades on XYZ until 2012/04/01

Result

For tax year 2011, the taxpayer has several constructive sales because Lot D causes 1259(c)(3)(A)(iii) not to be met by reducing the risk of loss of the original Lot A. The three constructive sales are:

1) Lot A by Lot B, recognizing $4 in gain
2) Lot A by Lot C, recognizing $2 in gain, since A's basis was previously adjusted to $14
3) Lot A by Lot D, recognizing $1 in gain, since A's basis was previously adjusted to $16

For the 2012 tax year, the taxpayer must recognize $7 in gain and Lot A's date is adjusted by these constructive sales to 2011/8/25 and cost basis is adjusted to $17.

It is clear that we will have $7 in gains from the chain of constructive sales. Unfortunately, the combined $4 loss from the covers may not be recognized due to the straddles that were created. Lot B and Lot C form offsetting positions to Lot A, thus creating two basic straddles. Therefore the entire $4 loss is potentially ensnared by the basic straddle.

Accepting that the $4 loss can be disallowed by the basic straddle, how does the taxpayer determine whether it is disallowed? To answer this question, the taxpayer must know the closing price of XYZ on 2011/12/31, the last date of the tax year. The excess of $4 loss over the unrecognized gain of Lot A can be claimed in 2011.

If the closing price is $17, the unrecognized gain on Lot A is $0, because the cost basis of Lot A has been raised to $17 by the constructive sales. In this case, a $4 loss can be recognized. If the closing price is $21, then the unrecognized gain on Lot A is $4 and the total amount of the $4 loss must be deferred until 2012. If the closing price is $18.50, then the unrecognized gain on Lot A is $1.50. The excess of the $4 loss over the $1.50 unrecognized gain is

$2.50 and this much loss can be recognized; the remaining $2.50 is deferred until 2012.

Section 9: Risk Reduction Issues

Part iii of the Closed Transaction Exception states "at no time during such 60-day period is the taxpayer's risk of loss with respect to such position reduced." In effect, this means it is far easier to continue a constructive sale once it has begun than it is to start one.

Example 20

Activity

This taxpayer uses calendar year as tax year.
2011/01/05 Lot A Buy 1 share XYZ @ $10
2011/03/02 Lot B Short 1 share XYZ @ $14
2011/04/30 Cover Lot B at no gain/loss
2011/05/30 Lot C Buy an option to sell (put) XYZ struck at $8 expiring in June 2012
No more trades on XYZ until 2012/04/01

Result

For tax year 2011, the taxpayer has a constructive sale (A-B) forcing a gain of $4. Although two of the conditions for the Closed Transaction Exception have been met, the 3rd condition fails as risk has been reduced within 60 days of Lot B being closed. Also, the Serial Hedge Exception rules are not satisfied. This is fairly straightforward.

Now imagine a similar case where the Put is acquired and disposed of before the short.

Example 21

Activity

This taxpayer uses calendar year as tax year.
2011/01/05 Lot A buy 1 share XYZ @ $10
2011/03/02 Lot B buy an option to sell (put) XYZ struck at $14 expiring in June 2012
2011/04/30 Lot B is sold at no gain/loss
2011/05/30 Lot C short 1 share XYZ @ $8
No more trades on XYZ until 2012/04/01

Result

For tax year 2011, there are no constructive sales. The put option reduces the risk on the stock but does not induce a constructive sale by itself. Later in May when the short is executed, the stock has dropped to $8 and A is no longer an AFP. Had there been a prior constructive sale, C would be considered to reduce the risk of loss on A; but since there was none, there is nothing to extend.

Section 10: Multiple Constructive Sales Simultaneously

Thus far we have concentrated on one exemption and one failure at a time. Let us now consider an example with two exemptions and one failure.

Example 22

Activity

This taxpayer uses calendar year as tax year. Assume taxpayer uses FIFO to retire open lots.
2011/01/05 Lot A Buy 1 share XYZ @ $10
2011/01/06 Lot B Buy 1 share XYZ @ $11
2011/03/02 Lot C Short 1 share XYZ @ $13
2011/03/03 Lot D Short 1 share XYZ @ $15
2011/04/29 Cover Lot C at no gain/loss
2011/04/30 Cover Lot D at no gain/loss
2011/05/30 Lot E Short 1 share XYZ @ $8
No more trades on XYZ until 2012/04/01

Result

There are two prospective constructive sales, A-C and B-D. Both are candidates for the Closed Transaction Exception. However the new short, Lot E, serves to "reduce risk," but for which constructive sale? There is nothing in the text of the Closed Transaction Exception that prevents Lot E from reducing risk on *both* constructive sales, making neither exempt. Most practitioners would take a small amount of risk (pardon the pun) and assume only one of the constructive sales applies and the other was exempted.

There are no rules currently in existence that govern this question. Furthermore, if the risk of only one of the long positions is diminished, there is no rule to explain which lot has had its risk diminished. However, the taxpayer may want to look for guidance to 26 CFR 1.246-5(c)(3), which describes a similar situation with regards to Dividend Received Deductions. So the taxpayer may either analogously apply this rule to the current situation or simply choose the one which is most advantageous.

Conclusion (Safe): Two constructive sales are recognized in 2011, one for $3 (A-C) and one for $4 (B-D).

Conclusion (Risky): One constructive sale for $3 (A-C) is recognized in 2011. B-D is exempted via the Closed Transaction Exception.

Note: Given the taxpayer is using FIFO, it is completely unacceptable to argue that they wish to recognize B-C as their single constructive sale for $2.

Conclusion

We see that the constructive sale rule in its basic form is very simple. But both the Closed Transaction Exception and the Serial Hedge Exception inject a great deal of complexity to a constructive sale analysis. In particular, the 60-day period, which can be cascaded forward by re-hedging, further complicates a prospective analysis of securities transactions for constructive sales. We also see that in some cases the regulations are ambiguous, such as whether risk can be reduced on more than one constructive sale with a single new trade. Furthermore, interactions with the straddle rule are ubiquitous. Although we realize it is impossible to provide advice on how to cope with all of these issues, we hope we have provided enough guidance to help practitioners comply with both the letter and spirit of the constructive sale rule.

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