



# Using Market Risk Concepts to Refactor Tax Shelters

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White Paper

IN ORDER TO COMPUTE ACCURATE PORTFOLIO TAX LIABILITIES, TAX PROFESSIONALS AND COMPLIANCE OFFICERS MUST COMPLY WITH THE FOLLOWING SECTIONS OF THE U.S.TAX CODE: WASH SALES, STRADDLES, CONSTRUCTIVE SALES, QUALIFIED DIVIDENDS, AND SHORT SALES. HOWEVER, VAGUE AND POORLY DEFINED TAX CODE VERBIAGE MAKES ABIDING BY THESE SECTIONS VERY TAXING. THIS PAPER OFFERS GUIDELINES BASED ON IDEAS FROM THE ECONOMIC SUBSTANCE DOCTRINE AND MARKET RISK MANAGEMENT TO FACILITATE COMPLIANCE WITH THESE SECTIONS. IN ADDITION, WE OFFER A MORE CONCRETE, ALTERNATIVE DEFINITION OF THE TERM "SUBSTANTIALLY IDENTICAL." LASTLY, THE PAPER PROPOSES THAT "SUBSTANTIALLY IDENTICAL" AND "OFFSETTING POSITIONS" SHARE ENOUGH IN COMMON AND SHOULD BE COMBINED INTO A SINGLE TERM. WE SUGGEST THIS CONSOLIDATION IN ORDER TO MAKE IT EASIER FOR TAXPAYERS TO UNDERSTAND AND MORE READILY COMPLY WITH THE TAX CODE.

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## INTRODUCTION

When Congress passed the Revenue Act of 1921, it not only introduced the concept of a “wash sale” to the tax code, but also introduced a new idea called “substantially identical.” A definition for “substantially identical” based on rulings since 1921 does exist in Pub 550, the IRS Publication that provides information and guidance on complying with sections of the Internal Revenue Code (IRC) that pertain to investment income and expenses. However, that text is quite ambiguous and leads to severe compliance headaches. Later, in 1981, when the Economic Recovery Tax Act (ERTA) was passed, Congress introduced a concept analogous to “substantially identical” called “offsetting position.” In 2010, Congress created I.R.C. §7701(o) of the tax code and codified the “Economic Substance Doctrine” (ESD). Unlike the language behind the terms “substantially identical” and “offsetting position,” the text in I.R.C. §7701(o) is reasonably clear cut. The ESD is an umbrella clause created to prevent taxpayers from executing any transactions that have no purpose other than the reduction or deferral of tax liability.

Tax professionals and compliance officers must be able to apply all of these concepts when attempting to correctly compute the tax liabilities of any portfolio. Unfortunately, because of unclear and poorly defined tax code terminology, readily understanding each of these concepts, both on an individual level and how they interrelate is quite a challenge.

The purpose of this paper is to suggest a way to refactor the tax code. Refactor is a computer science term that means to use a common theme to transform an existing code-base, improving on its elegance, integrity and efficacy without harming performance. In order to make sections of the tax code pertaining to tax shelters more readable and therefore compliance with them less of a headache, we propose refactoring/simplifying these sections based on ideas from the ESD and Market Risk Management.

## SECTION 1: NEED FOR A SIMPLIFIED TAX CODE

It is no secret that compliance with any section of the tax code is difficult. Understanding the thousands of pages of the IRC, even with its related explanatory material, presents countless challenges. Each year taxpayers seeking help with clarifications and explanations of the tax

code make no fewer than 100 million phone calls to the IRS, the federal government's revenue-collection arm. Individuals and businesses spend an estimated six billion hours a year trying to correctly meet their IRS filing requirements. The sheer density of the IRC, which contains 3.8 million words<sup>1</sup> (more than five times the number of words in the Bible) and its opaque language make compliance anything but straightforward. Unclear tax verbiage results in incorrectly filed tax returns by taxpayers who honestly want to abide by the law but make inadvertent errors. Sometimes this results in taxpayers overpaying the IRS. Unclear tax verbiage also invites tax shelter abuse by sophisticated taxpayers who find loopholes to help them reduce or eliminate their tax liabilities. This leads to some taxpayers underpaying the IRS and contributes to the estimated \$350 billion in lost annual tax revenue.<sup>2</sup>

If the tax code were easier to understand and abide by, this could result in a series of benefits: fewer compliance headaches, a decrease in tax shelter abuse and ultimately, more accurate tax bills and increased tax revenue for the U.S. Treasury. Clearly, to simplify and rewrite the IRC in its entirety would be an exercise in futility. We do, however, believe that the sections of the IRC that address tax shelter transactions — wash sales, constructive sales, straddles, qualified dividends, and short sales — can be made less obtuse and easier to follow.

## SECTION 2: CONGRESS' ATTEMPTS AT CURTAILING TAX SHELTER ABUSE

Tax shelters are designed to reduce taxable income and generate artificial capital losses in order to avoid and/or pay fewer taxes. For tax purposes, recognized losses, especially short-term capital losses, are always desirable; these short-term losses can wipe out your short-

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<sup>1</sup> National Taxpayer Advocate's 2008 Annual Report to Congress Urging Simplification of the Tax Code.

[http://www.irs.gov/pub/irs-utl/08\\_tas\\_arc\\_intro\\_toc\\_msp.pdf](http://www.irs.gov/pub/irs-utl/08_tas_arc_intro_toc_msp.pdf)

<sup>2</sup> Estimate based on a 2010 IRS report issued by the Tax Gap Subgroup:

<http://www.irs.gov/taxpros/article/0,,id=228971,00.html>

term capital gains and help you avoid having to pay the higher 35% tax rate and instead let you pay the lower tax rate of 15%. They can also cost the U.S. Treasury billions upon billions of dollars from lost annual tax revenue.

In an effort to try and recoup lost revenue and also spur economic growth, from 1921 to 2010, Congress introduced the following key pieces of legislation:

- The Revenue Act of 1921
- Economic Recovery Tax Act of 1981 (ERTA)
- Tax Relief Act of 1997 (TRA)
- Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)
- Health Care and Education Reconciliation Act of 2010

In general, these laws raised and/or lowered individual income tax rates and capital gains tax rates. They also address different taxable events (wash sales, straddles, constructive sales and qualified dividends) and describe under what conditions losses will be disallowed, thus attempting to shut down tax shelter abuse.

## A Brief History of Security Transaction Tax Shelters

Spearheaded by the Secretary of the Treasury Andrew Mellon as a way to stimulate economic growth after World War I, the **Revenue Act of 1921** not only differentiated taxation of capital gains from ordinary income but it also aggressively closed the most obvious of all tax shelters, the wash sale. In addition, it introduced a new and very loosely defined concept called “substantially identical,” and contained text referring to “substantially identical” securities and how they could not be used to circumvent the wash sale rule.

In 1981, as part of the Reagan–era tax cuts, Congress passed the **Economic Recovery Tax Act (ERTA)**, also known as the “**Kemp–Roth Tax Cut**” for its sponsors, Representative Jack Kemp of New York and Senator William V. Roth, Jr. of Delaware. This legislation closed another major tax shelter by creating the concept of the “Tax Straddle.” **Straddles** (I.R.C. §1092) were identified as being capable of generating book losses without any actual risk, and therefore subject to special tax treatment. With the addition of I.R.C. §1092, Congress introduced

“offsetting position,” a new concept to the tax code that is somewhat similar to term “substantially identical.”

Next, in an effort to balance the federal budget, President Bill Clinton signed the **Tax Relief Act 1997 (TRA)**. In addition to introducing sweeping tax cuts, this law identified and disallowed **constructive sales** (I.R.C. §1259) as an additional mechanism for riskless deferral of gains. “Substantially identical” is specifically mentioned in the language to describe constructive sales. However, the TRA did not define “substantially identical” since a working, albeit poor, definition already existed in the regulations and revenue rulings.

Later, President George W. Bush signed the **Jobs and Growth Tax Relief Reconciliation Act 2003 (JGTRRA)**, which included tax cuts on individual rates, capital gains, dividends and estate tax. It also created the concept of a **qualified dividend** (I.R.C. § 1(h)(11)), where days are not considered for the purpose of meeting the required holding period if “the recipient’s risk of loss was diminished.” This concept of tax reduction on corporation-to-individual dividend originates from I.R.C §243, the Dividend Received Deduction (DRD), which reduced tax on corporation-to-corporation dividend. We believe that since the term “risk” is introduced in this legislation, the rules for “offsetting position” can be used to determine when risk of loss is diminished.

And more recently, on March 30, 2010, the **Health Care and Education Reconciliation Act of 2010**, signed by President Barack Obama, officially added the **Economic Substance Doctrine**, I.R.C. § 7701(o) to the U.S. tax laws. Based on the ESD, a transaction does not have economic substance when it lacks a business purpose. The ESD functions as an umbrella clause for all the prior, current and future laws related to tax shelters that fail to correctly close any loopholes that might allow taxpayers to use securities transactions for the sole purpose of saving taxes. This new section of the IRC affects much of the tax code pertaining to income taxes. It creates an explicit fallback position for the IRS, where in certain cases, if a transaction is deemed not to have economic substance, that transaction shall be ignored, and its losses will also be ignored or disallowed.

## Refactoring

This paper identifies a common logic across the tax code pertaining to wash sales, straddles, constructive sales, qualified dividends and short sales. We suggest simplifications that would make it easier for a practitioner to allow his clients or employer to accurately comply with the tax rules and generate fair and accurate taxable gains. In order to accomplish this, we suggest changes based on unifying concepts that appear throughout the code and define them cleanly by borrowing some concepts from Market Risk Management. We do this with the understanding that the IRS requires a certain level of flexibility if it is to effectively collect tax revenues and help fill the coffers of the U.S. Treasury. Before we discuss these sections of the IRC in more detail, a brief discussion about risk management concepts is necessary.

## SECTION 3: RISK MANAGEMENT CONCEPTS

There are several forms of risk management used within the securities industry. Each is used as a tool to measure the potential effect of certain classes of adverse events. These include, but are not limited to, the following: counterparty risk, credit risk, settlement risk, liquidity risk, operational risk and market risk. There are other forms of risk management that come into play. Of particular note is the case of diversification of counterparty risk where a taxpayer might move an asset from one custodian to another by selling the shares at the first custodian and purchasing new shares at the other custodian. This kind of transaction does trigger a wash sale but does *\*not\** trigger I.R.C. §7701(o) because there is “substantial purpose for entering into the transaction.” However, this paper specifically addresses market risk, the most salient form of risk applied in the securities industry.

## Market Risk

The concept of risk management was technically invented in the 17th century by the mathematician Blaise Pascal and writer, amateur mathematician and gambler Antoine Gombaud, chevalier de Méré. However, it was not considered a mature science as applied to the financial markets until the middle of the 20th century when Harry Max Markowitz began publishing work in the 1950s that led to the introduction of the Capital Markets Pricing Model in the 1960s.

## G2 FinTech

Traditionally, market risk management involves studying a security or portfolio of securities to ascertain the amount of gain or loss possible within probable event boundaries. Different kinds of events (or shocks) can produce different positive or negative effects to different securities. For example, a rise in interest rates triggers a fall in bond prices. A professional risk manager measures market risk to determine the degree to which this relationship affects his portfolio. The end result is a set of ‘sensitivities’ that are derived mathematically by determining the partial differentials between the different events and the expected profit or loss of the portfolio. These partial differential equations (PDEs) are combined with stochastic measurements of the input variables to produce a single, simple measurement of risk.

Let’s continue with the interest rate example. By using standard statistical metrics of past data measurements, a risk manager first ascertains that he has a 95% confidence that interest rates will rise no more than 2% over the next 12 months. He then uses traditional bond value mathematics to derive that he will see an aggregate loss of \$1 million for each 1% rise in rates. He can therefore tell the fund manager that he has 95% confidence that the fund will lose no more than \$2 million over the next 12 months because of interest rate movements.

When computing the risk of an entire portfolio, measuring the risk of holding an individual security is only part of the process. Sometimes the risk of one security can ‘cancel out’ the risk of another security in the portfolio, and the risk manager must typically adjust for such correlations. For purposes of this paper, since it is not relevant for tax purposes, we will not discuss the mathematics behind this. We will, however, discuss two key concepts behind portfolio tax analyses — **risk equivalent** and **families of securities**.

### **Risk Equivalent, Families of Securities and Tax Analyses**

One of the most important tools of risk management is the measurement of economic similarities between specific securities. This is accomplished by applying the concepts of risk equivalent and families of securities to complete tax analyses for wash sales, straddles, constructive sales, qualified dividends and short sales.

**Risk Equivalent** – Two securities can be considered risk equivalent to one another if they share characteristics that demonstrate that the risk of loss incurred by holding one security can be mitigated by holding an offsetting position in the other security.



Risk equivalence is NOT transitive. Security A may share enough in common with Security B to be considered risk equivalent and in turn Security B can be risk equivalent to Security C. However, those factors that make A and B similar and those that make B and C similar need not be the same and therefore A and C have so little in common as not to be considered risk equivalent. It is not the goal of this paper to postulate what degree of similarity is required for risk equivalence, but simply to state that market risk management techniques should be used when trying to determine if a transaction has economic substance or business purpose.

**Families of securities** – Before beginning any tax analyses of a portfolio for wash sales, straddles constructive sales, qualified dividends or short sales, the practitioner must do three things:

1. Enumerate the securities that have been traded or held during the tax period in question
2. For purposes of wash sales and constructive sales, use cases that the Tax Court has already ruled on (precedence) and (where necessary) risk–equivalence assessments to analyze which securities, if any, are “substantially identical.” (We discuss “substantially identical” in detail in Section 4, Wash Sales, Substantially Identical and the Revenue Act of 1921.) Thanks to the ESD, risk–equivalence becomes critical for determining this relationship.
3. For purposes of straddles and qualified dividends, use a risk–equivalence assessment to determine which, if any, of these securities can be combined into positions that are “offsetting” to one another. (We discuss “offsetting” in detail in Section 4, Straddles and Emergency Recovery Tax Act 1981.)

Note that these relationships can sometimes change over time, e.g. an option going into the money, or the completion of a merger. The practitioner must create and maintain (throughout the analyses) these logical groups of securities as well as the nature of the relationship (“substantially identical” or “offsetting”). It can be true that a single security can belong to more than one group because, as stated above, risk equivalence is not transitive. It can also be true that two securities can offset one another but not be considered “substantially identical.” However, in all cases where a security is determined to be

“substantially identical” to a second security, opposite positions in those two securities will be considered “offsetting.”

Now we will explore in depth how these ideas should be used with respect to specific sections of the IRC.

## SECTION 4: MARKET RISK MANAGEMENT CONCEPTS AND THE INTERNAL REVENUE CODE

### Wash Sales, Substantially Identical and the Revenue Act of 1921

The Revenue Act of 1921 introduced wash sales and the term “substantially identical” to the tax code. The concept of a wash sale is pretty straightforward. A wash sale is generally described as selling stock at a loss, and buying “substantially identical” securities within 30 days before or after the sale. What’s not clearly defined is which securities qualify as “substantially identical.” Pub 550 offers an ambiguous definition at best:

*“IN DETERMINING WHETHER STOCK OR SECURITIES ARE SUBSTANTIALLY IDENTICAL, YOU MUST CONSIDER ALL THE FACTS AND CIRCUMSTANCES IN YOUR PARTICULAR CASE. ORDINARILY<sup>3</sup>, STOCKS OR SECURITIES OF ONE CORPORATION ARE NOT CONSIDERED SUBSTANTIALLY IDENTICAL TO STOCKS OR SECURITIES OF ANOTHER CORPORATION,” AND “SIMILARLY, BONDS OR PREFERRED STOCK OF A CORPORATION ARE NOT ORDINARILY CONSIDERED SUBSTANTIALLY IDENTICAL TO THE COMMON STOCK OF THE SAME CORPORATION.”*

### Flexibility for the IRS/ Headaches for Tax Professionals

By offering no clear definition of “substantially identical,” Congress gave the IRS a great deal of flexibility to rule on not only existing but future security types that could be used to manipulate realized gains and losses in order to avoid paying taxes. Subsequently, revenue rulings have been created to prevent taxpayers from using instrument types, such as stocks, call options, convertible bonds and convertible preferred shares, stock warrants, rights

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<sup>3</sup> This use of the word “ordinarily” has been incorporated from revenue rulings, such as Rev. Rul. 77-201, where a convertible preferred was deemed substantially identical to the common stock for reasons including price behavior and voting rights.

issues, U.S. Treasuries (in certain cases), put options, Government National Mortgage Association (GNMA) contracts (in certain cases) and futures contracts to circumvent the 1921 law and its successors. For example, in 1977, with Rev. Rul. 77-201, 1977-1 C.B. 250, convertible securities meeting certain criteria were clearly identified by the IRS as being “substantially identical” to the stock into which they were convertible. Section 5 below discusses these rulings in further detail.

The flexibility that resulted from the ambiguous language surrounding “substantially identical” clearly benefited the IRS. However, the opaque language behind this term has only compounded compliance headaches for tax professionals and compliance officers.

### Alternative Definition of Substantially Identical

In order to determine if you have a wash sale, you first need to determine if you bought “substantially identical” securities (to the stock you sold at a loss) within 30 days before or after the sale. Systematically and consistently identifying “substantially identical” securities from this vague verbiage and piecemeal rulings is no easy feat (though we attempt to make it easier in Section 5 of this paper). By borrowing terminology from the market risk management lexicon, we believe it is possible for the IRS to simplify the process of identifying what should or should not be “substantially identical.” If “substantially identical” were defined based on the concept of risk equivalent, this would make it easier to comply with the wash sale rule.

As is often the case with simplification, the results of a new definition will, in some cases, likely cause different outcomes as compared to the existing, more complex set of rules. However, if the effect is mostly the same and the spirit is maintained and no gaping loopholes are introduced, simplification is in the best interests of both the government and the taxpayer. With this in mind, we offer an alternative definition for “substantially identical.”

*SUBSTANTIALLY IDENTICAL: TWO SECURITIES CAN BE CONSIDERED SUBSTANTIALLY IDENTICAL TO ONE ANOTHER IF THEY SHARE CHARACTERISTICS THAT DEMONSTRATE THAT THE RISK OF LOSS INCURRED BY HOLDING ONE SECURITY CAN BE MITIGATED BY HOLDING AN APPROPRIATE POSITION IN THE OTHER SECURITY.*

This new definition should produce results quite similar to the existing hodgepodge. However, this new definition can be applied with considerably less effort and greater consistency, making compliance a simpler process. This alternate definition would immediately impact I.R.C. §1091 (wash sales), §1233 (short sales) and §1259 (constructive sales).

This risk-based definition of “substantially identical” also makes compliance with the ESD more straightforward. According to the ESD, a transaction is not considered to have economic substance if it has no business purpose other than saving taxes. Between 1921 and 2010 you could execute a sequence of trades that the IRS had not explicitly clarified to be a wash sale via a revenue ruling, yet allowed you to not substantially change your risk exposure and still realize losses for tax purposes. Once the ESD was incorporated into the tax code, this mechanism was not valid if these transactions had no other purpose than to save and/or avoid taxes. It is now true that any time you replace a position on a security with a position on a second security, where the change in holdings does not change your economic profile, you must pay taxes as if you had a wash sale.

This situation could be avoided if one of the most important tools of market risk management, the measurement of economic differences between specific securities, were applied. In some cases, the concept of risk has already been used by the Tax Court to rule on which transactions qualify as having “business purpose.”<sup>4</sup>

The ESD would be easier to abide by if the idea of a “riskless” transaction were used as one of the considerations in deciding whether something has economic substance. A riskless transaction is any trade or set of trades that generate zero or minimal net risk for the entity executing the transactions other than tax benefits. Accordingly, a practitioner needs to be proficient with both the theory and application of market risk management in order to comply with the interactions between the wash sale rule and the ESD.

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<sup>4</sup> “The Economic Substance Doctrine in the Current Tax Shelter Environment,” Remarks at the 2005 University of Southern California Tax Institute by Donald L. Korb Chief Counsel for the Internal Revenue Service  
[http://www.irs.gov/pub/irs-utl/economic\\_substance\\_%281\\_25\\_05%29.pdf](http://www.irs.gov/pub/irs-utl/economic_substance_%281_25_05%29.pdf)

“Substantially identical” was first used in the definition of a wash sale and also appears in the code pertaining to short sales and constructive sales. The term is not used in the sections on straddles and qualified dividends. However, the word “risk” is used in both of these sections. So if “substantially identical” has been redefined based on the concept of risk, then we can now unify all of these sections. Let’s see how our risk-based alternative definition of “substantially identical” can be used to modify the language behind §1092 (straddles) and §246 (qualified dividends) to make it harder to creatively game the tax code.

## Straddles and the Emergency Recovery Tax Act 1981

The ERTA 1981 addressed the use of tax straddles, a flagrant form of tax abuse popular in the 1960s and 1970s when commodities brokers used risk management techniques to help generate artificial losses for their clients. The clients then used these highly desirable short-term losses to offset gains and essentially delay the need to pay taxes on a perpetual basis. The mechanism was simple. If the investor holds a large portfolio of real estate and generates gains from buying and selling these properties, normally they would have to pay capital gains taxes. To avoid this, the investor of the 1960s would buy a ‘Tax Straddle’ from a broker. The Tax Straddle is constructed by creating two opposing positions in two risk-equivalent securities. One of the positions is long and the other is short. As market factors fluctuate, one of the two positions will generate a gain, and the opposing leg, because it is offsetting to the first, will generate a similar loss.

The investors wait until just before the calendar year ends to sell off the position with the loss in order to realize a short-term loss. This short-term loss cancels the gains from the real estate portfolio and eliminates the need for the investors to pay taxes on those gains. They still hold an open position with a large unrealized gain, but they can hold that indefinitely (preferably after they die) until they are ready to realize that gain. The reader may notice that if the investors are holding only one of the two positions, they now have market risk, which is bad. To repair this, the investors simply buy back a new position on the same or some other risk-equivalent security as soon as the new calendar year starts (being careful to avoid the wash sale rules). The brokers loved this because it created a whole new marketplace for them in which to harvest commissions. The tax-paying investors loved it because they could

indefinitely postpone paying taxes. (Please see [Tax Implications of Straddles](#) for a more in-depth discussion on this topic.)

### Offsetting Positions and Risk Equivalent

The ERTA 1981 closed down this flagrant tax shelter abuse of straddles. In general terms, a straddle is a pair of transactions that is created by taking two offsetting positions, often two positions sharing the same underlying security. One of the two positions holds long risk and the other is short. Pub 550 describes **Offsetting position** as follows: *“THIS IS A POSITION THAT SUBSTANTIALLY REDUCES ANY RISK OF LOSS YOU MAY HAVE FROM HOLDING ANOTHER POSITION.”*

In this case, we actually see the word ‘risk’ included into the tax code. By 1981, risk management was a mature science and the concepts had become main stream, especially in the world of financial derivatives, which are the primary building blocks of tax straddles. So, if the definition of “substantially identical” was changed to only depend on a concept like risk-equivalence, with risk-equivalence being defined sufficiently loosely, then we could change the text of I.R.C. § 1092 to state: *A STRADDLE IS DEEMED TO EXIST WHEN THE TAXPAYER USES A SECOND POSITION IN THE SAME OR SUBSTANTIALLY IDENTICAL SECURITY TO DIMINISH THE TAXPAYER’S RISK OF LOSS IN THE FIRST POSITION.*

### Constructive Sales and the Tax Relief Act 1997

Until 1997, taxpayers with short-term unrealized capital gains were able to systematically convert those unrealized short-term gains into realized long-term gains with no tax penalty. Since short-term capital gains tax rates are far more punitive than long-term tax rates, this behavior was commonplace. This was done as follows:

Normally, a loss or gain is recognized for tax purposes only when a position is sold off or retired. For a long position, this occurs when the shares are sold and for a short position, this happens when the short position is covered. This makes intuitive sense as the taxpayer needs only see tax effects when he actually disposes of his positions. Unfortunately, this seemingly simple view of the world can be used to exploit the tax code. Imagine a taxpayer who owns some shares of ABC stock and that stock has appreciated nicely. The taxpayer wants to take his profits and sell the stock, but would prefer not to pay taxes. Prior to 1997,

he could accomplish this by simply shorting a number of shares in ABC equal to his long position and holding two 'open' positions (one long and one short) and therefore not recognizing any gain. Because the two positions, when considered in aggregate, have a net effect of the taxpayer owning no shares, the taxpayer has effectively liquidated his very profitable trade, locked in his gains and paid no taxes on it! This tactic is known as a 'Constructive Sale' or a 'Short-Versus-the-Box.'

Constructive sales were aggressively used by hedge funds to both convert short-term gains into long-term gains as well as serving as a mechanism to delay those gains from being realized for as long as is convenient. Even after this practice was nullified in 1997, some boxes are still being held by hedge funds to this day. This is because the constructive sale rule only applies on the day the second position is entered into.

The United States Congress had become concerned during the early 1990s with various tax shelter strategies developed by Wall Street brokerage houses to permit hedge funds and wealthy investors to reduce, defer or eliminate tax liabilities. There was pent up demand in Congress to see these tax shelters closed. So when the Taxpayer Relief Act of 1997 was signed into law by President Bill Clinton in August 1997, many of these loopholes were closed. In total, the TRA 1997 resulted in more than 800 changes to the already massive tax code.

According to Pub 550, a constructive sale of an appreciated financial position occurs when you *"ENTER INTO A SHORT SALE OF THE SAME OR SUBSTANTIALLY IDENTICAL PROPERTY"* (or similar types as defined in I.R.C. §1259(c)(1)).

Although "substantially identical" is not defined in I.R.C. §1259, the term has the same meaning as it does in I.R.C. §1091. Both 1259 (constructive sales) and 1091 (wash sales) use the term "substantially identical" as an integral part of their text. Certain rules for "substantially identical" are laid out in short sales ((26 CFR 1.1233-1(d)), and any interpretation and/or modification of this text should be applied to all sections.

As with wash sales, by clarifying the definition of “substantially identical” by using concepts from the risk management lexicon, the text of I.R.C. §1259 could be simplified, achieve similar results and be far easier to follow. Also, similar to wash sales, the IRS still expects correct tax treatment even when a taxpayer creates a constructive sale by mistake as the byproduct of a legitimate trade.

## Qualified Dividends and the Jobs and Growth Tax Relief Reconciliation Act 2003

On May 28, 2003, President George W. Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). This law reduces the tax rate for dividends produced by securities that have been held as long-term investments. Traditionally, dividends were taxed as ordinary income for investors and therefore this income was taxed at the highest possible rate. As a result, many investors would encourage companies NOT to pay dividends but rather use the cash for mergers and acquisitions or other activity that is exempt from taxation and which would still add value for the shareholder. In order to ‘unlock’ this cash for distribution to shareholders, this provision of the JGTRRA was included to encourage companies to behave more ‘normally.’

I.R.C. § 1(h)(11) defines when dividends are qualified for preferential tax treatment (0% or 15% minimum rate). There is a holding period requirement to be eligible for the lower tax rate. However, not counted are days where “a taxpayer has diminished his risk of loss.” (See [Qualified Dividend Income](#) for more information on this topic.)

So, you cannot determine whether a dividend qualifies for the minimum tax rate unless you understand when and if risk of loss is diminished. Therefore, the very same tools you would use to determine whether two securities are risk-equivalent (for purposes of straddles) could also be used to determine when to adjust the holding period for dividend qualification. Once again, if a satisfactory definition of “substantially identical” can be achieved, the guidelines for deciding when ‘risk of loss was diminished’ can be made easier to follow. The qualified dividend text now could read: *A TAXPAYER HAS DIMINISHED HIS RISK OF LOSS BY MEANS OF AN APPROPRIATE POSITION IN THE SAME OR SUBSTANTIALLY IDENTICAL SECURITY.*



## Short Sales

The alternative risk-based definition we offer for “substantially identical” can also be used to streamline compliance with the tax code addressing short sales (I.R.C. § 1233). This section has rules that can cause gains on short positions to be short-term, and gains to be long-term, if “substantially identical” property to the property being shorted is held. (Please see [Wash Sale Implications of Short Sales](#) for more information.)

## Economic Substance Doctrine (ESD) and the Health Care and Education Reconciliation Act of 2010

On March 30, 2010, a little known section of the tax code, subsection I.R.C. §7701(o) the “Economic Substance Doctrine,” was slipped into the Health Care and Education Reconciliation Act of 2010. The idea behind this subsection was to prevent taxpayers from executing tax shelter transactions—transactions that had no purpose other than saving taxes. To determine whether or not a transaction has economic substance, it must meet two criteria. “A

*TRANSACTION IS TREATED AS HAVING ECONOMIC SUBSTANCE ONLY IF (A) THE TRANSACTION CHANGES IN A MEANINGFUL WAY (APART FROM FEDERAL INCOME TAX EFFECTS) THE TAXPAYER’S ECONOMIC POSITION, AND (B) THE TAXPAYER HAS A SUBSTANTIAL PURPOSE (APART FROM FEDERAL INCOME TAX EFFECTS) FOR ENTERING INTO SUCH TRANSACTION.”<sup>5</sup>*

The ESD cemented a fallback position for the IRS in the case that a taxpayer attempted to use a straddle, constructive sale, wash sale or other tax shelter by using security classes that technically were not considered “offsetting” or “substantially identical,” but nonetheless had identical effects. An example might be the use of a Total Return Swap (TRS) to replace a physical equity position. There is no ruling that classifies a TRS as “substantially identical” to the underlying common stock. Up until 2010, a taxpayer might try to create wash sales using swaps as replacement positions for realized losses in common stock positions and claim that the loss was legitimate. This paper would claim that since “substantially identical” is so

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<sup>5</sup> IRS memo on the Codification of Economic Substance Doctrine and Related Penalties  
<http://www.irs.gov/businesses/article/0,,id=242254,00.html>

poorly defined, that a TRS may or may not qualify as a wash sale. However, with I.R.C. §7701(o) in place, in order to recognize the loss for tax purposes, the taxpayer would also need to show that there was a valid business reason for the transaction.

The ESD was officially added to the tax code in 2010. However, a Supreme Court case dating back to the 1930s, Gregory v. Helvering (1935), is credited for laying the foundation of this doctrine. In this landmark case, the Supreme Court addressed the question of whether a tax-free reorganization took place where the taxpayer had no intent to carry on the existing corporate business, only a desire to minimize taxes.

Another doctrine, the **doctrine of business purpose**, overlays and is often considered together with the ESD. According to the doctrine of business purpose, essentially if a transaction has no substantial business purpose other than the avoidance or reduction of Federal tax, the tax law will not regard the transaction. *“IN ESSENCE, A TRANSACTION WILL ONLY BE RESPECTED FOR TAX PURPOSES IF IT HAS “ECONOMIC SUBSTANCE WHICH IS COMPELLED OR ENCOURAGED BY BUSINESS OR REGULATORY REALITIES, IS IMBUED WITH TAX-INDEPENDENT CONSIDERATIONS, AND IS NOT SHAPED SOLELY BY TAX-AVOIDANCE FEATURES THAT HAVE MEANINGLESS LABELS ATTACHED.””*<sup>6</sup>

When auditing the results of **any** portfolio’s security transactions, the I.R.C. §7701(o) categorically forces the tax professional to take into account economic substance. *“THE ECONOMIC SUBSTANCE DOCTRINE CAN APPLY EVEN WHEN A TAXPAYER EXPOSES ITSELF TO RISK OF LOSS AND WHERE THERE IS SOME PROFIT POTENTIAL (I.E., WHERE THE TRANSACTIONS ARE REAL) IF THE FACTS SUGGEST THAT THE ECONOMIC RISKS AND PROFIT POTENTIAL WERE INSIGNIFICANT WHEN COMPARED TO THE TAX BENEFITS.”*<sup>7</sup> Accordingly, this paper takes the position that the most effective way to do so is to use well-understood tools from risk management.

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<sup>6,7</sup> Joint Committee on Taxation, *Description and Analysis of Present-law Tax Rules and Recent Proposals Relating to Corporate Tax Shelters* (JCX-84-99), November 10, 1999.

## SECTION 5: CURRENT DEFINITION OF SUBSTANTIALLY IDENTICAL

As discussed, the IRS has not provided a clear-cut definition of “substantially identical.” Rather, it has put forth a collection of rulings that augment the text in the tax code and address a discrete list of security classes (stocks, call options, convertible bonds and convertible preferred shares, stock warrants, rights issues, U.S. Treasuries (in certain cases), put options, GNMA contracts (in certain cases) and futures contracts. These rulings have been created over the years to clarify the meaning of the text in the Revenue Act of 1921 and its successor tax codes. Until the IRS clearly defines “substantially identical” and other terms, right now compliance officers and tax professionals must rely on these specific rulings to help them determine which securities qualify as “substantially identical.” The following is a list of the most pertinent sections of the tax code, revenue rulings and General Counsel Memoranda (GCM) that are used to determine when securities are classified as “substantially identical” or are otherwise pertinent for the determination of wash sales:

1. **Stocks.** *“IN A REORGANIZATION, THE STOCKS AND SECURITIES OF THE PREDECESSOR AND SUCCESSOR CORPORATIONS MAY BE SUBSTANTIALLY IDENTICAL.”* (Pub 550)

Stocks can be replaced by successor stocks in a merger. This relationship is bi-directional and in some cases the predecessor can replace the successor (the Buy-Buy-Sell case).

2. **Call Options.** *“HAS ENTERED INTO A CONTRACT OR OPTION SO TO ACQUIRE, SUBSTANTIALLY IDENTICAL STOCK OR SECURITIES.”* ((I.R.C. §1091(a))

Stocks can be replaced by call options as specifically mentioned in the code itself.

3. **Convertible Bonds and Convertible Preferred Shares.** *“WHERE THE BONDS OR PREFERRED STOCK ARE CONVERTIBLE INTO COMMON STOCK OF THE SAME CORPORATION, THE RELATIVE VALUES, PRICE CHANGES, AND OTHER CIRCUMSTANCES MAY MAKE THESE BONDS OR PREFERRED STOCK AND THE COMMON STOCK SUBSTANTIALLY IDENTICAL.”* (Pub 550)

*"CONVERTIBLE PREFERRED STOCK THAT HAS THE SAME VOTING RIGHTS AS THE COMMON STOCK, IS SUBJECT TO THE SAME DIVIDEND RESTRICTIONS, SELLS AT PRICES THAT DO NOT VARY SIGNIFICANTLY FROM THE CONVERSION RATIO, AND IS UNRESTRICTED AS TO CONVERTIBILITY IS, FOR PURPOSES OF THE WASH SALE PROVISIONS, SUBSTANTIALLY IDENTICAL TO THE COMMON STOCK AND IS ALSO CONSIDERED AN OPTION TO ACQUIRE SUCH STOCK. "* (Rev. Ruling 77-201)

A number of factors must be considered when determining whether convertible bonds and convertible preferred stock are "substantially identical" to the common stock into which it is convertible. Among these is whether the convertibility is restricted or not.

- 4. Stock Warrants.** *"WHERE STOCK WARRANTS ARE SOLD AT A LOSS AND COMMON STOCK OF THE SAME CORPORATION IS SIMULTANEOUSLY PURCHASED, THE LOSS IS ALLOWABLE UNLESS THE RELATIVE VALUES AND THE PRICE STRUCTURE OF THE TWO ARE SO SIMILAR AS TO MAKE THEM SUBSTANTIALLY IDENTICAL. HOWEVER, A LOSS IS NOT ALLOWABLE WHERE COMMON STOCK IS SOLD AT A LOSS AND WARRANTS FOR COMMON STOCK OF THE SAME CORPORATION ARE PURCHASED SIMULTANEOUSLY."* (Revenue Ruling 56-406)

Therefore, stock is not usually "substantially identical" to warrants (except when deep in the money), but warrants can be a replacement for stock, since they are "a contract or option so to acquire "substantially identical" stock or securities." ( I.R.C. §1091(a))

- 5. Rights Issues.** *"THE WASH SALE PROVISIONS ARE APPLICABLE WHERE A TAXPAYER ACQUIRES STOCK THROUGH THE EXERCISE OF SUBSCRIPTION RIGHTS AND WITHIN THIRTY DAYS THEREAFTER SELLS AN EQUAL NUMBER OF SHARES OF THE STOCK WITH RESPECT TO WHICH THE RIGHTS WERE ISSUED."* (Revenue Ruling 71-520)

When acquiring stock, it does not matter if this stock was bought on the open market, or acquired through exercising subscription rights. Although this ruling does not specifically address what is considered "substantially identical," it highly relevant for purposes of selection of securities to serve as replacement securities.

6. **U.S. Treasuries.** Different treasury issues are SOMETIMES “substantially identical” to one another. (Revenue Rulings 58–210 and 58–211)
7. **Put Options.** *“A LOSS ON THE SALE OF CORPORATE STOCK, OTHERWISE ALLOWABLE UNDER SECTION 165, IS DISALLOWED UNDER SECTION 1091, IF, WITHIN 30 DAYS OF THE SALE OF STOCK, THE TAXPAYER SOLD AN “IN-THE-MONEY” PUT OPTION WITH RESPECT TO THE STOCK AND, BASED ON THE OBJECTIVE FACTORS AT THE TIME THE PUT WAS SOLD, THERE WAS NO SUBSTANTIAL LIKELIHOOD THAT THE PUT WOULD NOT BE EXERCISED.”* (Revenue Ruling 85–87)

A short put is considered “a contract to acquire stock” under some circumstances, notably being in-the-money.

8. **GNMA contracts.** Different GNMA contracts can be “substantially identical” to one another. (General Counsel Memorandum 39551)
9. **Futures Contracts.** GCM 38369 (referenced in 39551) says that treasury futures are considered “substantially identical” to treasuries for the purpose of 1091. Revenue Ruling 71–568 says that commodity futures are not considered as “stock or securities” for the purposes of I.R.C. §1091(a).

## Categorizing Loss Recognition

Regarding securities that are not addressed above, tax professionals and compliance officers can use the following categories to help determine what losses the IRS will disallow.

1. **Black** – There is a specific revenue ruling indicating two items are substantially identical.
2. **Dark Gray** – It seems very likely that the IRS would rule that these are “substantially identical.” Case in point, using total return swaps to replace single stocks.

3. **Gray** – There are cases where you have a high probability that the IRS would rule “substantially identical” but for which no revenue ruling currently exists. Many of these are due to subsection 1091(e), which was created in 1984 and created the existence of wash sales for short positions. It is implicit (but not explicit) that the short-sale versions if all the cases above exist. For example, if you cover a short position and then write a sufficiently in-the-money call, there is no revenue ruling that this is a wash sale. However, it can be inferred that item (6) above could be interpreted in its mirror-image form and be disallowed.
4. **Totally Murky** – Items (2) and (5) above show that sometimes treasuries and convertible securities are and sometimes are not “substantially identical” to each other. It can be anybody's guess which way the IRS (and if that ruling were challenged, the Tax Court) might rule.
5. **White** – There is a revenue ruling (example rev. rul. 71-568 pertaining to commodities futures) that clearly denotes a case is NOT subject to I.R.C. § 1091.

## SECTION 6: CONCLUSION AND EXPECTED FUTURE DEVELOPMENTS

Tax shelter abuse is an undesirable but natural consequence of our complex and lengthy tax code, which is fraught with ambiguous language and terminology. The proliferation of options, swaps, futures and other derivative securities has served to create a cornucopia of new ways for tax shelters to be constructed. To help combat this reality, Congress can use risk management concepts to clarify and strengthen the tax code. By modifying and linking the definitions for “substantially identical” and “offsetting positions,” Congress could make compliance much more straightforward.

It is the goal of this paper to request that the drafters of tax law take the bull by the horns, elucidate the text and clarify the interactions of I.R.C. §246, 7701, 1259, 1233, 1091 and 1092. This would result in several positive side effects. Compliance would be far easier. Taxpayers would end up paying more or less the same taxes, yet spend less time preparing

their returns (or paying someone else to do it). If taxpayers spend less time and money preparing their taxes, then they can spend more time participating in positive economic activity.

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