Constructive Sales of Appreciated Financial Positions

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In the mid-90's, Congress realized that certain taxpayers were utilizing several financial transactions to reduce, and in some cases, eliminate their risk of loss on appreciated financial positions without actually having a taxable disposition. In many cases, taxpayers were able to access cash as if the appreciated positions had been sold while also deferring tax liability that would have resulted from an actual sale of the position. In order to curb these practices, Congress enacted Internal Revenue Code (the Code) Section 1259 in 1997. Code Section 1259 provides for "constructive sale" treatment for appreciated financial positions.

A "constructive sale" generally occurs, with respect to an appreciated financial position (AFP), where an investor enters into a short sale of "substantially identical" property, enters into an offsetting notional principal contract with respect to substantially identical property, or enters into a futures or forward contract to deliver substantially identical property.

An AFP for purposes of the constructive sale rules is any position with respect to any stock, debt instrument, or partnership interest if there would be gain if that position was sold, assigned, or otherwise terminated at its fair market value. Examples of AFPs are a long position where the value of the stock has increased since the purchase date, or a short sale position where the value of the stock has decreased since the date that the taxpayer borrowed shares of the stock and sold them short.

The term "substantially identical" is not well-defined in the Code and taxpayers must generally rely upon applying the guidance available for the wash sale rules to their facts and circumstances. While stocks and securities of one corporation are generally not ordinarily considered substantially identical to stocks and securities of another corporation, stocks and securities of corporations involved in a re-organization could be considered substantially identical. In addition, certain derivative instruments on securities held, such as forwards and options, may constitute substantially identical offsetting positions. A taxpayer that desires to hedge their exposure to a security without triggering

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the constructive sale rules may choose to short the stock of a different company that is expected to replicate the price movements of the long stock position. Due to the lack of direct guidance defining what constitutes a substantially identical position for purposes of Code Section 1259, it is important to consult with your tax advisor to determine the impact of a potential transaction designed to hedge the downside risk of a position held before entering such transaction.

If a taxpayer is deemed to have a constructive sale of an AFP then *(i)* the taxpayer must recognize gain as if such position was sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale; *(ii)* the taxpayer must make proper adjustments in the amount of any gain or loss subsequently realized with respect to such position for any gain taken into account by reason of a constructive sale; and *(iii)* the holding period of such position shall be determined as if such position were originally acquired on the date of such constructive sale.

If a taxpayer held an AFP, and wished to acquire a substantially identical offsetting position, certain exceptions exist that may provide relief. Three types of transactions are excluded from the definition of "appreciated financial position:"

- Any position with respect to straight debt if *(i)* the position unconditionally entitles the holder to receive a specified principal amount; *(ii)* the interest payments or other similar amounts with respect to the payment are based on either a fixed or qualifying variable rate that is permissible for REMIC regular

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interests; and *(iii)* such position is not convertible (directly or indirectly) into stock of the issuer or any related person;

- Any hedge with respect to a position in straight debt; and
- Any position which is marked to market under any Code section or the Regulations under those Code sections. Thus, a constructive sale does not include a transaction involving an AFP that is marked to market, including positions governed by Code Section 475 (mark-to-market for securities dealers) or Code Section 1256 (mark-to-market for regulated futures contracts, options and currency contracts).

In addition, the constructive sales rules do not apply to the following situations:

Non-publicly Traded Property: Under this exception, a taxpayer is not treated as having made a constructive sale solely because the taxpayer enters into a contract for sale of any stock, debt instrument, or partnership interest which is not a marketable security if the contract settles within one-year after the date the contract is entered into. A marketable security is any security for which, as of the date of the disposition, there was a market on an established securities market.

Closed Transactions: Under this exception, any transaction (which would otherwise cause a constructive sale) during the tax year will be disregarded if:

- The transaction is closed on or before the 30th day after the close of the tax year (the extended tax year);
- The taxpayer holds the appreciated financial position to which the transaction relates throughout the 60-day period beginning on the date the transaction is closed; and
- At no time during that 60-day period is the taxpayer's risk of loss with respect to the position reduced by reason of holding certain other positions (i.e., hedged).

As long as a taxpayer meets the requirements for this exception the taxpayer can engage in transactions such as "short sales against the box" (i.e., where a taxpayer borrows and sells shares identical to the shares the taxpayer holds) without a constructive sale occurring. However, the taxpayer must remain at risk (i.e., unhedged) with respect to the AFP for the 60 days after the closing of such short. If a taxpayer fails to meet the requirements for the exception (i.e., by not closing the transaction on or before the 30th day after the close of the tax year), the constructive sale occurs on the date the taxpayer entered into the transaction.

If a transaction (which would otherwise cause a constructive sale) is closed and reestablished with a substantially identical position, the closed transaction exception should still apply provided that the substantially identical position is closed before the end of the tax year and requirements two and three (i.e., 60-day holding period and 60-day prohibition on reducing risk via other positions) are met after the original transaction is closed.

The above summary briefly describes the basics of constructive sales and is not intended to be applicable to any individual investment or tax situation. The constructive sales rules are very complex and include several important exceptions. We suggest that each taxpayer consult his or her tax advisor regarding any possible constructive sale.

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