INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-131174-11

Director
Associate Area Counsel (Denver) (Large Business & International)

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Bank 1 =
Bank 2 =
ABC =
XYZ =
ABC Corporation =
DEF Corporation =
XYZ Corporation =
Debentures =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
m	=
n	=
o	=
p	=
q	=
r	=
s	=
t	=
u	=
v	=
w	=
x	=
y	=
z	=
aa	=
bb	=
cc	=
dd	=
ee	=
ff	=
gg	=
hh	=
ii	=

jj =
kk =
ll =
mm =
nn =
oo =
1 =

ISSUE:

Whether Taxpayer's exercise of the Puts resulted in closed and completed transactions for federal income tax purposes.

CONCLUSION(S):

Taxpayer's exercise of the Puts resulted in closed and completed transactions for federal income tax purposes.

FACTS:

On Date 1, Taxpayer, through its wholly owned and controlled subsidiaries,[1] entered into four share option transactions ("Transactions")[2] with Bank 1. Each Transaction was styled as a collar that consisted of European-style put and call options, also commonly known as a variable forward contract (VFC),[3] expiring between a and b years from the effective dates of the Transactions.

Except for dates and small variations in the strike prices of the puts and calls under each confirmation, the material terms of the Transactions were otherwise identical. Each Transaction initially involved c options, and each option initially referenced one

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2 A fifth identical Share Option Transaction was also entered into at this time with a settlement date of Date 3. This Transaction is not at issue because Taxpayer physically settled it with the pledged shares prior to Date 3 on Date 4.

3 The agreements provided that a European option is only exercisable only at expiration of the option. Nevertheless, as discussed below, two of these options were exercised or partially exercised early.

share of ABC stock. Thus, each Transaction initially referenced c shares of ABC stock held by Taxpayer for more than one year, for a total of d shares. By expiration, the references to both the number and types of shares changed, as described below.

Pursuant to the confirmations, by Date 1, ("Trade Date"), Taxpayer was required to deliver c shares as security for each Transaction ("Collateral Shares"). Bank 1 thus received a perfected security interest in the Collateral Shares, including any additions and proceeds (collectively, "Collateral") as security for Taxpayer's performance obligations under the Transactions with full recourse to Taxpayer. All Collateral was credited to a securities account opened by an affiliate of Bank 1 as the collateral custodian.

Each Transaction was styled as a collar with two options: a call option ("Call") sold by Taxpayer to Bank 1 and a put option ("Put") purchased by Taxpayer from Bank 1. The "strike price" of the Put was equal to e% of the initial stock value. The "strike price" of the Call was equal to f% of the initial stock value. For example, for Transaction 1, the strike prices of the Put and Call were initially $g and $h, respectively. The initial strike prices of the options in the four Transactions varied slightly depending on the market value of the stock as of the effective date of a Transaction.

The confirmations also provided for adjustments to the strike prices of the options as well as other changes to the settlement terms, such as number and type of shares, including the possible creation of a "share basket," due to various adjustment and merger events. If adjustments were made to the strike prices due to the payment of cash dividends or similar cash distributions actually received by Bank 1 with respect to the Collateral Shares, then Bank 1 generally was required to pay these amounts to Taxpayer and all other distributions ("Excluded Distributions") were to be retained by Bank 1 as additional Collateral. Ultimately, due to the reorganization of ABC Corporation's capital structure at Date 5, ABC Corporation's spin off of its DEF Corporation business, and DEF Corporation's subsequent merger with XYZ Corporation, each share of ABC stock held by Taxpayer was replaced with a "basket" consisting of (1) hh shares of ABC stock and (2) i shares of XYZ stock. As a result of these various events and/or distributions made with respect to the stock, including extraordinary dividends paid in Year 1, Year 2, and Year 3, the final Put and Call strike prices varied significantly from those provided in the initial pricing notices.

The confirmations required a Call premium to be paid by Bank 1 and a Put premium to be paid by Taxpayer, which were netted. In all four collars, the Call premium paid by Bank 1 exceeded the Put premium paid by Taxpayer, and after netting, Taxpayer received a net amount. The confirmations provided that the Put and Call options were linked so that neither option could be "transferred or terminated independently of the other." If either option is exercised by physical settlement, the other option is terminated automatically and neither party shall have further rights or obligations with respect to the

Transaction. The default for settlement was cash settlement, unless Taxpayers requests physical settlement prior to expiration date, as discussed below.

Under the confirmations, Bank 1 is entitled to terminate the Transaction early under certain events, including certain hedging disruption events where it experiences an increase of m basis points or more in its borrow costs for hedging its position in the Collar or is unable to maintain its hedge position. A hedging disruption event can be prevented if Taxpayer lends shares to Bank 1 or pays the excess borrow costs. Bank 1 agrees to borrow the shares, under a customary stock lending agreement, at Taxpayer's request as necessary to hedge Bank 1's position in the Transactions. Taxpayer has represented that no such stock lending agreement was ever executed between the parties.

Under the confirmations, cash settlement is the default settlement mechanism for the Transactions. Under the agreements, cash settlement means that Taxpayer will pay Bank 1 an amount equal to the cash value of the difference between the strike price of the Put or Call and the settlement price multiplied by the number of options exercised or deemed exercised. The settlement price is the price per share, as set out in the confirmation. Under the Put, Bank 1 is required to pay Taxpayer an amount equal to the greater of (a) the excess of the strike price over the settlement price and (b) zero. Under the Call, Taxpayer is required to pay Bank 1 an amount equal to the greater of (a) the excess of the settlement price over the strike price and (b) zero. Thus, if the settlement price of a share is less than the strike price of the Put, then Taxpayer will receive the difference between the settlement price and the Put strike price. If the settlement price of a share is greater than the strike price of the Call, then Bank 1 will receive the difference between the settlement price and the Call strike price. If the settlement price is less than the Call strike price and greater than the Put strike price, then, under the confirmations, neither party is required to make a payment to the other.

Under the confirmations, Taxpayer may elect physical settlement. Under the agreements, physical settlement means that upon exercise of a Put or Call, Bank 1 will pay the settlement price to Taxpayer and Taxpayer will deliver to Bank 1 the number of shares or baskets to be delivered, as the case may be. No shares are deliverable if neither option is exercised.

According to Taxpayer, it gave notice for physical settlement for all four Transactions.

Guaranty between Taxpayer and Bank 1

Also on Date 1, Taxpayer and Bank 1 entered into a Guaranty under which Taxpayer unconditionally guaranteed payment when due of all present and future obligations and liabilities arising out of the collar confirmations and any advances made or credit extended. Identical guarantees were executed for each collar transaction. The

Guaranty gives Bank 1 the option to set-off and reduce, at its option, any amounts owed by it to Taxpayer by amounts payable by Taxpayer under the Guaranty .

Funding Transaction between Taxpayer and Bank 1

The confirmations provided for a funding transaction under which Bank 1 could advance funds to Taxpayer. Pursuant to a confidentiality agreement dated Date 6, Bank 1 (or an affiliate) would advance Taxpayer an amount up to the value of the Collateral Shares. The confirmations did not provide for early repayment of these advances in the event of a decline in the value of the Collateral Shares.

Subsequently, on Date 7, Taxpayer and Bank 1 executed a "Loan and Pledge Agreement" ("LPA") under which Taxpayer could obtain up to $n ("Commitment"), which was increased to $o on Date 8. Under the LPA, the Commitment could be increased if the market value of the Collateral Shares increased or if the present value of the Puts increased. If the market value of the Collateral Shares increased, Bank 1 would have discretion whether to increase the Commitment, subject to certain conditions, including whether either party has exposure at any time under the Collars. However, the LPA indicated that the agreement would not require Taxpayer to deliver anything besides the Collateral. If the present value of the Puts increases, then Bank 1 is obligated, at the request of Taxpayer, to increase the Commitment such that the present value of the Puts were not greater than the Commitment.

Pursuant to these agreements, each transfer of cash was evidenced by a "Note." Each Note referenced a specific Transaction and was payable by the settlement date of that Transaction. Both the Collateral Shares and the share option transactions were pledged as collateral for the Notes, including all other amounts received with respect to the collateral. Under the agreements, if a Note is outstanding as of the bth day prior to the settlement date, the Collateral for the Note would be used to repay the Note, unless Taxpayer elects to pay in cash. If the Collateral would be used to satisfy Taxpayer's obligations under a Note and the share option transactions, Bank 1 agreed to "release its security interest in the Collateral" for this purpose. In addition, Bank 1 could call the outstanding Notes early in the event of a default under either the Notes or the Transactions.

Bank 1 and Taxpayer executed at least p Notes between Date 9 and Date 10. Taxpayer paid interest to Bank 1 monthly at a variable rate of q%. The funds were used, with one exception, for general corporate purposes.[4]

As of Date 10, Taxpayer had incurred a total balance of $r. After the Date 4 settlements, Taxpayer ultimately repaid a total of $s in principal and accrued interest as the remaining share option transactions were settled. The summary sheets for the four

[4] There was one borrowing of $w on Date 8 used to retire Debentures and repaid on Date 11.

collar Transactions show that Taxpayer's adjusted basis in the shares include interest on the Notes.

Settlement of the Share Option Transactions

Early partial settlement of Transaction 1 (original settlement date of Date 2) on Date 4

On Date 4, Taxpayer settled t% of the Put for Transaction 1 by delivering u of its own ABC shares and v of its own XYZ shares to Bank 1. Taxpayer received a cash payment of $x from Bank 1 and recognized taxable gain in Year 4 on this amount as well as on a portion of the premium received on or around Year 1, $y; there remained $z of the premium unrecognized.[5] Thus, with respect to Transaction 1, Taxpayer continued to own aa% of the shares related to this Transaction, as noted below.

Settlement of remaining share option transactions at expiration in Year 5

The remaining four share option transactions were settled on their expiration dates in Year 5. Pursuant to settlement terms provided for the Transactions, settlement would occur in three steps. First, Taxpayer would repay the advances of cash from Bank 1 by wiring Bank 1 proceeds equal to the face amount of the Notes plus accrued interest. Next, Bank 1 would wire the collar settlement value to Taxpayer. Finally, it was anticipated that the Collars would be settled by Taxpayer's delivery of the underlying shares in the baskets.

Instead of delivering the shares pledged as collateral for the Transactions, Taxpayer settled the Transactions with shares obtained through a Master Securities Loan Agreement ("MSLA") with Bank 2, described in detail below. Taxpayer obtained bb shares of ABC stock and cc shares of XYZ stock from Bank 2. Bank 2 transferred these shares directly to Bank 1. The shares that were pledged as collateral for the Transactions were then transferred directly to Bank 2 to be used as collateral under the MSLA. The settlement terms for the collar do not specify the delivery of either borrowed or Collateral Shares.

At expiration of the four Transactions, the shares of ABC had a quoted trading price between $dd and $ee per share and the XYZ shares were between $ff and $gg per share. Based on these quoted trading prices, the market price per basket, consisting of hh shares of ABC stock and i shares of XYZ, was between $j and $k.

The Put price per ABC share was $ii and the Put price per XYZ share was $jj; each basket had a Put price of $kk. Because the final price of each basket was less than the Put price of each basket, the Put was exercised by Taxpayer. Under the agreements, where an option is to be physically settled, the "settlement price" for each option is

[5] The fifth collar was also settled at this time, Date 4, by physical delivery of pledged shares and gain was recognized.

equal to the Put price multiplied by the number of deliverable shares. When the four Transactions expired, Bank 1 paid approximately $ll to a wholly owned subsidiary of Taxpayer, equal to the total number of deliverable shares per Transaction multiplied by the appropriate Put price per basket. As discussed above, when the Transactions were settled, Taxpayer also repaid the amounts owed under the Funding Transactions with Bank 1. Taxpayer indicated that they repaid the advances to Bank 1 and then Bank 1 paid the Collar proceeds to Taxpayer.

Master Securities Loan Agreement between Bank 2 and Taxpayer

As discussed above, Taxpayer advised that it closed out the remainder of the Transactions with Bank 1 by delivery of shares obtained from Bank 2. Several months before the expiration of the Transactions, on Date 11, Taxpayer and Bank 2 executed agreements including a MSLA and Annex that set forth the various terms and conditions for multiple future stock loans. The Annex provided that Taxpayer was not a “customer” of Bank 2, and the parties were to be are acting as principals for their own accounts .

In order to cover Taxpayer’s settlement obligations under each of the four Transactions for ABC and XYZ shares, Taxpayer advised that it executed a total of eight stock loans with Bank 2, or two per Transaction. Each stock loan confirmation contained the specific terms of each stock loan. Taxpayer provided the execution dates of the various loan confirmations and the closing dates of the related Transactions.
Under these agreements, Bank 2 (or an affiliate), as securities lender, would physically transfer securities to Taxpayer (“Loaned Shares”), as securities borrower, in exchange for a physical transfer of collateral by Taxpayer (“Loan Collateral”); a loan could not occur without these transfers unless otherwise agreed to by the parties. Under the stock loan, Bank 2, as lender, was obligated to deliver the shares to Taxpayer or its designee. As noted above, ultimately Bank 2 transferred the Loaned Shares directly to Bank 1 and Bank 1 transferred the shares pledged as collateral for the Transactions directly to Bank 2 where they became Loan Collateral. Neither the agreements nor the stock loan confirmations provide an expiration date for the stock loans, however, either party may terminate a stock loan by giving three days notice. Under the MSLA, Taxpayer was to acquire all incidents of ownership in the borrowed shares .

Under the MSLA, Bank 2 remains entitled to all distributions made with respect of the Loaned Shares. Such distributions include any distribution made with respect to the Loaned Shares such as cash, all other property, stock dividends, and other distributions. Cash distributions received by Taxpayer are to be paid by Taxpayer to Bank 2 and non-cash distributions are added to the Loaned Shares.

The Loan Collateral could consist of any property mutually agreed to by the parties. As noted above, the Loan Collateral was in fact the same type and number of the Loaned Shares (i.e. non-cash Loan Collateral), which was specifically contemplated by the agreements. Because the Loan Collateral and the Loaned Shares were the same, the value of the Loan Collateral always equaled the value of the Loaned Shares. Bank 2 has the first priority secured interest in the Loan Collateral and is required to segregate it from its other assets. The Loan Collateral was initially transferred to an account with Bank 2. Taxpayer is entitled to all distributions made on non-cash Loan Collateral. (same definition of "distributions" for both Loan Collateral and Loaned Shares). Taxpayer is to pay any cash distributions received with respect to the Loan Collateral to Bank 2 and any non-cash distributions become additional Loan Collateral.

Originally, under the MSLA, Bank 2 was permitted to retransfer or rehypothecate the Loan Collateral. However, notwithstanding the MSLA, Bank 2 agreed not to rehypothecate the Loan Collateral, unless Taxpayer consents in writing, or a Stock Loan is terminated, or other default events occur. Taxpayer has advised that the Loan Collateral has not been lent to Bank 2 .

Under the agreements, Taxpayer is required to pay a loan fee to Bank 2 based on the market value of the Loaned Shares since the Loan Collateral for the stock loan is not cash and such fee is payable either periodically or upon termination of the loan. Taxpayer has advised that share lending fees of $mm were paid to Bank 2 during Year 5.

In general, the MSLA provides that all of the agreements between Bank 2 and Taxpayer comprise a single agreement and that the parties agree that their respective obligations and rights under the stock loans may be offset and netted against each other. Note that because the Loan Collateral is the same type and amount of property as the Loaned Shares, the MSLA appears to require that any cash distributions Bank 2 is obligated to pay to Taxpayer with respect to the Loan Collateral and Taxpayer is obligated to pay to Bank 2 with respect to the Loaned Shares be offset. Similarly, non-cash distributions with respect to the Loan Collateral and the Loaned Shares should also offset such that the amount of the Loan Collateral and Loaned Shares would not increase. These assumptions appear to have been confirmed by the Taxpayer.

Currently, our understanding is that the stock loans are ongoing and that Taxpayer has no plans to close out the stock loans at this time.

Taxpayer's Position

The field office believes Taxpayer will report, on their Year 5 Federal income tax return, a § 1259 constructive sale gain of $nn. The inclusion of this amount is not in dispute. The field office also believes that since Taxpayer did not disclose the deferred gain amount in its disclosures, it does not plan to report the deferred gain of $oo.

Taxpayer proposes treating the settlement of the Puts in Year 5 as "open" transactions with a recognized capital gain of $nn under § 1259. Taxpayer proposes to treat the pledged shares as its appreciated financial position under § 1259(b). The values of the

ABC and XYZ shares used in its gain calculation were the quoted market prices at the settlement dates. The tax basis of the ABC and XYZ shares included both the Taxpayer's historical basis in the shares and capitalized interest paid to Bank 1 pursuant to the Loan Agreement dated Date 7. The interest was not deducted on prior year tax returns. Taxpayer asserts that a straddle was created by the Loan Agreement, and the interest on the loan was properly capitalized under § 263(g) and added to the basis of the underlying stock. The straddle that was created involves a short position and a long position. The short position was the loan under the Collars secured by the underlying ABC and XYZ shares. The long position was holding other ABC and XYZ shares. Therefore, the capitalized interest was added to the tax basis of the ABC and XYZ shares at the time of the § 1259 gain calculation under § 1092.

Taxpayer has stated that at the expiration dates of the Collars, it elected physical settlement under the contracts and delivered an aggregate of bb ABC shares and cc XYZ shares to Bank 1. Bank 1 was required to make cash payments to Taxpayer equal to the Put price multiplied by the number of shares underlying the Puts. Because Taxpayer wanted to retain the ABC and XYZ shares that it held, it borrowed bb ABC shares and cc XYZ shares from Bank 2 and delivered these borrowed shares to Bank 1 to settle the Collars.

Taxpayer asserts that the delivery of the borrowed shares to settle the Collar contracts is a short sale and a constructive sale of bb ABC shares and cc XYZ shares under § 1259 of the Internal Revenue Code. However, Taxpayer argues that the deemed gain is limited by the quoted market price of the pledged shares, as opposed to the fair market value of the Collars, on the date the Collars were settled. Taxpayer designated the bb ABC shares and the cc XYZ shares as the shares "deemed" sold for § 1259 purposes. Taxpayer is recognizing $nn capital gain under § 1259 on the Year 5 tax return, which is the difference between Taxpayer's basis in the shares deemed constructively sold and their fair market value.

Taxpayer claims that the $w premium payments (premiums remaining after partial settlement in Year 4) should not be recognized in Year 5 when the Collars are settled. It claims that its settlement of the Puts is consistent with a typical short sale transaction, in which the short seller first contracts to sell the shares at a fixed price and then borrows the shares to settle the sale contract. Taxpayer claims that the physical settlement of the Puts with shares borrowed from Bank 2 is treated as a short sale, and the transaction should be treated as "open" until such time as Taxpayer delivers ABC and XYZ shares to Bank 2 to close out its short position.

Taxpayer claims that the cash prepayment of $w is treated as additional proceeds received in connection with a short sale of the ABC and XYZ shares delivered to settle the Puts. Taxpayer relies on Rev. Rul. 78-182, 1978-1 C.B. 265. In that ruling, the premium received for writing a put option is not included in income at the time of receipt, but is carried in a deferred account until the writer engages in a closing transaction.

Under its short-sale theory, Taxpayer claims that there is an open transaction and the recognition of the premium is deferred. Taxpayer also claims that the $d paid at the time of settlement of the Puts is not recognized and becomes part of the "open" transaction.

Taxpayer is relying on § 1.1233-1(a)(1), § 1259, Rev. Rul. 2004-15, 2004-1 C.B. 515, and Rev. Rul. 72-478, 1972-2 C.B. 487, to continue to defer the gain under the short sale. It is relying on Rev. Rul. 78-182 to continue to defer the gain on the cash prepayment.

Law and Analysis

Under all four Transactions at issue in this case, Taxpayer exercised the Puts while the Calls lapsed unexercised because the value of the stock baskets had fallen below the strike price of the Puts.[6] As discussed above, Taxpayer elected physical settlement with respect to all four Puts, pursuant to the terms of the agreements. In summary, the steps of the settlement were as follows:

(1) Taxpayer repaid the cash advances from Bank 1 pursuant to the LPA.
(2) Bank 1 wired the put settlement value to Taxpayer.
(3) Taxpayer obtained the reference shares from Bank 2 pursuant to the MSLA.
(4) Bank 2 transferred the reference shares to Bank 1 on behalf of Taxpayer in settlement of the Puts that Taxpayer reported as constructive sales of the Pledged Shares under § 1259(c)(1)(A).
(5) Bank 1 transferred the Taxpayer's Pledged Shares to Bank 2.
(6) Bank 2 holds the Taxpayer's shares as collateral under the MSLA.

The agreements between Taxpayer and Bank 1 do not differentiate between physical settlement by delivery of the pledged shares or delivery of other shares that are acquired by Taxpayer for delivery. The agreements do not require delivery of the pledged shares.

Issue #1: Did the exercise of the Puts result in a "closed and completed" transaction for federal income tax purposes?

[6] Taxpayers may seek to characterize collar transactions of this nature as variable forward contracts, a characterization that the Service has not challenged. Taxpayer may prefer in the current context to characterize the collars as options. Our opinion has not been sought on whether the transactions should be respected as separate put and call options for federal income tax purposes. There are a number of associated issues. For instance, it is unclear whether Taxpayer has taken into income, either in the past or with these transactions, the premium and gain that was realized on its written call options that expired out-of-the-money. Related thereto, the Service would need to consider whether Taxpayer is making an unauthorized change of its accounting method, the duty of consistency doctrine, and other related law. In short, Taxpayer's current characterization of the collar transaction as separate options may give rise to other effects that we are not advising on in this technical advice.

The Puts were closed upon settlement by their terms.

In general, a contract that is settled by its terms is a closed and completed transaction for federal income tax purposes and must be currently accounted for. Commissioner v. Union Pacific Railroad Co., 86 F2.d 637 (2nd Cir. 1936); Frost Lumber Industries v. Commissioner, 128 F.2d 693 (5th Cir. 1942); Delaware Corp. v. Commissioner, T.C. Memo. 2004-280; Keith v. Commissioner, 115 T.C. 605 (2000); § 1.1001-1(a) (gain or loss is realized from the conversion of property into cash). The exercise of a put is a closed and completed transaction for federal income tax purposes. Rev. Rul. 78-182; Rev. Rul. 71-521, 1971-2 C.B. 313; Rev. Rul. 58-234, 1958-1 C.B. 279, clarified by Rev. Rul. 68-151, 1968-1 C.B. 363. See also, Notice 2003-81, 2003-2 C.B. 1223, modified and supplemented by Notice 2007-71, 2007-35 I.R.B. 472 (option writer's transaction "stays open without any ascertainable income or gain until the writer's obligation is finally terminated, without exercise, or otherwise. . . . When the option writer's obligation terminates, the transaction closes. . ." [cites omitted]).

The method by which an option is exercised, for instance cash settlement or property settlement, does not alter the conclusion that the exercise of a put option is a taxable event for federal income tax purposes. Under Rev. Rul. 88-31, 1988-1 C.B. 302, exercise of a cash settlement option is treated as a sale or exchange of the option. See also Samueli v. Commissioner, 661 F.3d 399 (taxable event occurs upon the closing of a contractual right to purchase or receive securities, regardless of fact that right was settled by offset).

In this case, the option rulings do not provide authority for deferring recognition beyond the exercise of the Puts. Generally amounts received by a taxpayer without restriction as to use are includible in income when received. See § 451; North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). The option rulings cited above generally provide that a payment received in return for writing an option is deferred until the option is exercised, lapses or is otherwise terminated. See Rev. Rul. 78-182. However, the option rulings make clear that the deferral only extends *until* the exercise, lapse or other termination of the option contract, at which point the premium is accounted for.[7]

Taxpayer recognized gain equal to the value of the Puts at settlement.

Generally, the rules for determining the amount of gain or loss on the exercise and settlement of a derivative contract assume either a cash settlement (i.e., no share delivery) or property settlement with seller's own shares. See e.g. Rev. Rul. 88-31, Rev. Rul. 78-182, and Rev. Rul 71-521. In the instant case, Taxpayer chose to settle with borrowed shares. Taxpayer may attempt to argue that so long as it has not

[7] As discussed above, in this case Taxpayer received net option premium attributable to the Call option component of the collar transaction. Because the Call expired unexercised, Taxpayer must recognize income equal to the gross premium on the expired Call under Rev. Rul. 78-182. The gross premium paid for the Puts would reduce the amount realized upon exercise of the Puts.

identified specific shares with the exercise of a put, then the option remains open for tax purposes because the amount of gain from the put is not reasonably determinable. Taxpayer may further argue that settlement with borrowed shares – which must eventually be repaid with other shares that are currently unidentified – would reach that same result.[8]

The purpose of the open transaction doctrine is to relieve a taxpayer from having to report income that may never be received. For example, in Burnet v. Logan, 283 U.S. 404, 413 (1931), the Court concluded that the transaction was not "closed" because taxpayer might never recoup its capital investment. The open transaction doctrine is a "rule of fairness designed to ascertain with reasonable accuracy the amount of gain or loss realized upon an exchange, and, if appropriate, defer recognition thereof until the correct amounts can be accurately determined." Dennis v. Commissioner, 473 F.2d 274, 285 (5th Cir.1973). The open transaction treatment applies only in "rare and extraordinary circumstances." McShain v. Commissioner, 71 T.C. 998, 1004 (1979); Parrish v. Commissioner, T.C. Memo. 1997-474 (1997), aff'd, 168 F.2d 1098 (8th Cir. 1999). The open transaction doctrine is only applicable when it is not possible to determine the value of either of the assets exchanged. Davis v. Commissioner, 210 F.3d 1346, 1348 (11th Cir. 2000).

Under the Puts, Taxpayer had the right to cash settle the contract, deliver the pledged shares or deliver other shares. Had Taxpayer settled in cash, it would have received a fixed amount of gain equal to the difference between the exercise price of the put and the fair market value of the stock. This amount is the value of the Put itself. This is the same net value received if Taxpayer goes into the market at closing and purchases shares to be delivered under the higher Put exercise price. If, on the other hand, Taxpayer delivered the pledged shares, it would recognize not only the value of the Put, but also the gain already embedded in the pledged stock, which had a basis well below its current fair market value. Because Taxpayer decided to deliver borrowed shares, however, it may argue that there is no way to compute with reasonable certainty the "total" amount realized on the exercise of the Puts and so all gain should be deferred. As a result, Taxpayer will assert that the transfer is not a "closed and completed" transaction for federal income tax purposes and the entire amount of cash should go untaxed until the subsequent, and unrelated, borrowing transaction is closed.

When considering the federal income tax consequences upon exercise of the Puts, it is important to differentiate between the amounts received representing profit on the Puts and amounts received representing gain that could be recognized upon the sale of the

[8] Some taxpayers may reference Reinach v. Commissioner, T.C.Memo. 1965-288, aff'd 373 F.2d 900 (2nd Cir. 1967), cert. denied 389 U.S. 841 (1967), as authority for holding open the Puts. The Tax Court noted that the years in which the call options were exercised were not before it, except with respect to a claimed carryback and therefore the issue whether the call options remained open was not presented. Rather, the primary issue was whether stock sold short by a purported trader was held primarily for sale to customers. Thus, the case does not speak to the issue presented in this memo.

pledged shares. Amounts received for the Put value are in all cases “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.” Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

The Put value must be recognized upon closing of the Puts. The Put value embedded in the Puts and received by Taxpayer is a fixed amount of gain paid by Bank 1 in settlement of the Puts that is clearly realized for federal income tax purposes. This amount of gain is completely independent of any future event relating to the borrowed shares and unrelated to Taxpayer’s basis (or lack of basis) in any particular shares. The Put value was not realized under the stock borrowing and MSLA transaction; it arose solely out of Taxpayer’s position under the Puts and is not offset by any liability to return shares.

As a result, there is a fixed amount of gain, clearly realized under the Puts, and completely unrelated to the independent borrowing transaction – the difference between the cash received and the fair market value of the shares.

Issue #2: What is the character of the gain recognized upon the exercise of the Puts?

The tax treatment given to option contracts is subject to a unique set of rules. As discussed above, under these rules, the exercise of a put option, whether by cash settlement or property settlement, is treated as a sale or exchange. Rev. Rul. 88-31 (exercise of a cash settlement option is treated as a sale or exchange of the option).

Section 1234(a)(1) provides that gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).

Section 1234(c)(2)(A) provides that for purposes of subsections (a) and (b) – treatment of gain or loss in the case of the purchaser or the grantor of an option on stock, securities or commodities – a cash settlement option shall be treated as an option to buy or sell property. Section 1234(c)(2)(B) provides that for purposes of this paragraph (A), the term “cash settlement option” means any option which on exercise settles in (or could be settled in) cash or property other than the underlying property [emphasis added]. Section 1234(c)(2)(B) was enacted in order “to clarify that gain or loss on the sale, exchange, lapse or exercise of the option is capital gain or loss with respect to grantors or holders.” H.R. Rep. No. 861, 98th Cong., 2d Sess. 904 (1934), 1984-3 (Vol. 2) C.B. 158. Congress also stated that “[a]s under present law, the receipt of cash on exercise of a cash settlement option is a taxable event.” Id. Accord Rev. Rul. 88-31; A.M. 2007-008 (a payment of cash made by the grantor of a call option to settle the grantor’s obligations under the option is a sale or exchange of the option by the holder). Rev. Rul. 78-182 provides that under § 1234(a)(1), gain or loss attributable to the sale or exchange of an option shall be considered gain or loss from the sale or exchange of property which has the same character as the stock; and that the holding period of the option is determined under § 1222.

Section 1.1234-1 provides that the period for which the taxpayer has held the option determines whether the capital gain or loss is short-term or long-term.

As a result, gain on the exercise of the Puts will be treated as long-term capital gain pursuant to § 1234.

Conclusion

As stated above, a fundamental tenet of the tax law is to tax similar economic results in a consistent manner. Generally, in order to carry out this mandate, the tax law does not distinguish between cash settled contracts and contracts that are settled with the seller's pledged property or other property, whether purchased or borrowed for delivery.

In this case, Taxpayer takes a position that would indefinitely defer recognition of income realized upon exercise of an option simply because Taxpayer delivered borrowed shares. Under this argument, the later and completely unrelated borrowing transaction affords the Puts a tax treatment that they could not otherwise receive, and that is inconsistent with the tax treatment applied to any other settlement method for option transactions. Taxpayers cannot be allowed to so easily thwart the fundamental tenets of our tax system and create significantly disparate treatment for economically similar positions.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.