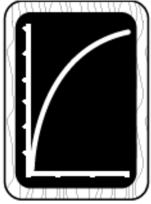

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Demystifying Section 1260 – Using Options Under the Constructive Ownership Rules

Background

Section 1260 of the U.S. Internal Revenue Code (the "Code") was enacted in 1999 in response to a specific targeted tax planning strategy that involved writing derivatives on hedge funds. Many hedge funds generally adopt investment strategies that involve frequent trading, resulting in short-term capital gains and losses for U.S. federal income tax purposes. The funds generally are treated as partnerships for tax purposes, i.e. entities that pass through trading gains and losses to their investors on a current basis. Thus, direct investors in the funds are taxed on a current basis on their distributive share of gains at the higher short-term capital gains rate.

To plan around this result, financial engineers structured derivative products, such as forwards, option strategies and swaps, which provided investors with substantially all of the economic exposure to hedge funds without actually owning the fund interests. Prior to the enactment of Section 1260, investors took the position that income on these derivatives, if properly structured, was recognized only upon a sale or termination of the derivative—i.e., on a deferred basis—and that such gains were long-term capital gains if the derivative was held for more than one year. Section 1260 was enacted to rectify this perceived abuse, i.e., the conversion of short-term capital gains taxable on a current basis into long-term capital gain taxable at a lower tax rate on a deferred basis. While hedge funds were the primary target of Section 1260, the provision covers certain derivatives based on a wide range of underlying asset classes, including most exchange traded funds.

Legislative or regulatory developments that target specific uses of derivatives in tax planning generally result in a natural market reaction that attempts to plan around the new constraints to the extent possible. Section 1260 is no exception. As discussed below, the primary planning opportunity is presented by the defined scope of the term "constructive ownership transaction." For well-structured strategies involving derivatives, such as paired option structures, it remains possible to comply with Section 1260 and at the same time retain the benefits of the use of derivatives to gain significant exposure to underlying assets that would otherwise produce inefficient tax results.

Impact of Section 1260

The definition of a "constructive ownership transaction" generally includes derivatives such as a swap, a forward contract, certain paired option strategies and, under regulations yet to be prescribed, transactions that have substantially the same effect. Under Section 1260, if a taxpayer has long-term capital gain from a "constructive ownership transaction" with respect to certain financial assets then such gain is recharacterized as ordinary income to the extent it exceeds the long-term capital gain that the taxpayer would have recognized had the taxpayer owned the underlying directly.

In addition, Section 1260 imposes an interest charge on the deferral of gain recognition. It requires the taxpayer to allocate the recharacterized gain to each taxable year of the taxpayer's holding period on the basis that the gain accrued during each year at the applicable federal rate (AFR). The taxpayer then must pay an interest charge at a prescribed rate on the underpaid tax for each period.

For example, suppose that the taxpayer entered into a three-year delta one forward contract on a hedge fund partnership interest, and suppose that the taxpayer had a net gain at the end of the three-year period of USD110. Assume that the taxpayer would have had only USD10 of long-term capital gain if he held the partnership interest directly. Section 1260 applies as follows. First, USD100 of the taxpayer's gain is treated as ordinary income. Second, the taxpayer is required to allocate the USD100 recharacterized gain to each of the prior three years. Finally, the taxpayer must pay the underpaid tax for each year as well as the applicable interest charge. The tax and interest charge are paid in the year of disposition; amended tax returns are not required.

Limits of Section 1260

Section 1260's legislative history indicates that the term "constructive ownership transaction" is intended to cover transactions that "replicat[e] the economic benefits of direct ownership of a financial asset without significant change in the risk-reward profile with respect to the underlying transaction." In addition, practitioners view the scope of Section 1260 as being governed to a significant extent by the rules that apply to Section

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1259 "constructive sale" transactions, which generally are thought only to include transactions that eliminate "substantially all" of the taxpayer's risk of loss and opportunity for gain with respect to the underlying asset.

According to the legislative history of Section 1259, one approach that might be an appropriate implementation of the "substantially all" trigger for purposes of Section 1259 is an approach based on options pricing and option pricing models. In the case of many derivatives strategies (including the one described below, but not necessarily forward contracts, which are subject to differing rules under Section 1260 and Section 1259), practitioners have adopted the "substantially all" test for purposes of Section 1260, including reliance in appropriate cases on options pricing and options pricing models. A word of caution: the approach discussed below is not directly supported by statute or regulation.

Suppose that a taxpayer wishes to enter into a derivatives strategy with respect to an ETF. ETFs generally are treated as financial assets within the meaning of Section 1260. The taxpayer wishes to enter into a strategy that would deliver, to the extent permitted by Section 1260, economic exposure to the underlying ETF without triggering the application of Section 1260. If the taxpayer acquires an at-the-money call option and sells an at-the-money put option, Section 1260 would undoubtedly apply because that strategy provides the taxpayer with total price-return exposure to the underlying ETF. As an alternative, therefore, the taxpayer opts instead to acquire an out-of-the-money call option and sell an out-of-the-money put option. How, though, to set the strikes in a manner that would avoid application of Section 1260?

Under one options pricing approach, a measure of the aggregate opportunity for gain with respect to an ETF is the premium of an at-the-money call option on the ETF, and a measure of the aggregate risk of loss with respect to the ETF is the premium of an at-the-money put option. Therefore, a measure of the total economic exposure with respect to the ETF is the sum of the two. Further, a measure of the upside exposure foregone by acquiring an out-of-the-money call option rather than an at-the-money call option is the difference between the premium of the ATM call option and the OTM call option. Finally, a measure of the foregone risk of loss by acquiring an OTM put option rather than an ATM put option is the difference between the premium of the ATM put option and the premium of the OTM put option. Generally, if the value of the sum of the foregone opportunity for gain and the foregone risk of loss represents more than 20% of the total economic exposure, practitioners generally conclude that the taxpayer is not exposed to substantially all of the opportunity for gain and risk of loss with respect to the ETF and, accordingly, that Section 1260 should not apply to the strategy. Some practitioners may be equally comfortable with a looser standard.

Consider the iShares MSCI Emerging markets ETF (ticker EEM), which is a regulated investment company under Section 851 and thus a financial asset for purposes of Section 1260. EEM recently was trading at approximately USD42. At the same time, January 2011 options on EEM were trading as follows: the USD42 call was priced at approximately USD5.50; the USD42 put at USD6.50; the USD47 call at USD3.45; and the USD37 put at USD4.20. Under the options pricing approach, a taxpayer who acquired the USD47 call and sold the USD37 put would have foregone opportunity for gain and risk of loss equal to the sum of (USD5.50 – USD3.45) and (USD6.50 – USD4.20), or USD4.35. The measure of total economic exposure is (USD5.50 + USD6.50), or USD12. Thus the ratio of foregone economic exposure to total economic exposure is roughly 36%. Under current law, Section 1260 should not apply to this strategy.

Final Word

Interestingly, structured notes on ETFs, or exchange traded notes on ETFs, that provide the same exposure as the options strategy discussed above may nonetheless be subject to Section 1260. The reason is that special rules apply to forward contracts under Section 1260. Specifically, the term may be read to include contracts that provide economic exposure that represents less than substantially all of the possible economic exposure.

While the statute grants regulatory authority that could narrow the scope of the term, no regulations have yet been issued. Because there is a significant risk that structured notes, or ETNs, may be viewed as forward contracts or as containing an embedded forward contract within the meaning of Section 1260, under current law there is a risk that, even if a structured note delivers less than substantially all of the economic exposure to the underlying, the note may nonetheless be subject to Section 1260. That said, even if it does apply, the manner in which Section 1260 applies to any particular structured note may not be entirely certain, especially where the structured note provides exposure that is capped, leveraged or interrupted by embedded digital options. However, the statute contains a presumption that maximizes the gain subject to recharacterization unless a lesser amount thereof is established by the taxpayer "by clear and convincing evidence."

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