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Identified Straddle Rules Fixed by Technical Corrections

by Biruta P. Kelly and Peter H. Winslow

The recent technical corrections legislation signed into law on Dec. 29, 2007, the Tax Technical Corrections Act of 2007, Pub. L. 110-172, contains a provision that improves the identified straddle rules. The identified straddle rule of section 1092(a)(2) permits a taxpayer to select positions in a straddle and thereby avoid surprise applications of the straddle rules by the IRS on audit.

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Background—The Basic Straddle Rules

The basic thrust of the section 1092 straddle rules is to defer the recognition of losses on positions in a straddle where the taxpayer continues to hold gain positions of the straddle that were offsetting to the loss positions. Offsetting positions result where a taxpayer has a substantial diminution of risk of loss in personal property by reason of the holding of one or more other positions (*i.e.,* a hedge). Where a company may have numerous offsetting positions, it is useful to be able to identify the offsetting positions in a straddle to ensure the application of the loss deferral rules will be as anticipated. Otherwise, insurance companies could find themselves in a difficult position upon an IRS examination where they sold derivatives at a loss. For example, the IRS could take the position on audit that a short position is a straddle with the company's entire bond portfolio, and thereby attempt to disallow the loss "permanently" as long as there was unrecognized gain in the company's bonds. The IRS could adopt this position even though the offsetting positions were "unbalanced," *i.e.,* where the derivative positions were small as compared to the entire bond portfolio.

Although the straddle rules as originally enacted in 1981 contained a provision that allowed taxpayers to identify positions in a straddle, it was not a practical solution. This is because the provision applied only where all the positions of the straddle were acquired on the same day and they had to be disposed of on the same day. Due to these practical limitations, the identified straddle rules were not used. Instead, taxpayers resorted to "self-help" identification for hedges of capital assets that do not qualify for the tax hedging exception from the straddle rules. Support for the self-help approach could be found in PLR 199925044 (June 28, 1999), where the IRS National Office stated that in the absence of regulations providing rules for dealing with unbalanced positions under section 1092(c)(2)(B), it was permissible for taxpayers to identify shares of stock that were part of a straddle. However, with these type of self-help attempts, there was no certainty that such identification would be respected by the IRS, or apply more broadly to other types of straddles.

2004 Legislative Changes to Straddle Rules

Because of the identification problems and threat of a permanent disallowance on audit, taxpayers—including life insurance companies—approached Congress for a change in the identification rules. In response to these requests, in 2004, the identified straddle rules were modified to permit identification of any straddle as long as it was made before the close of the day on which the straddle was created. The 2004 legislation also changed the operation of the recognition of straddle losses with respect to identified straddles. Normally a straddle loss is disallowed under section 1092(a) only to the extent of the unrecognized gain in the offsetting positions. This means that the loss is recognized without the disposition of the offsetting position, so long as the loss exceeds the amount of unrecognized gain in the offsetting positions at the close of the year. In 2004, the new identified straddle rules adopted a different rule for recognition of losses in the identified straddle:

> [I]f there is any loss with respect to any identified position of the identified straddle, the basis of each of the identified offsetting positions in the identified straddle shall be increased by an amount which bears the same ratio to the loss as the unrecognized gain with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all such offsetting positions.

This rule posed a technical issue where there was no unrecognized gain in the offsetting positions. Potentially,

the loss could be disallowed permanently under the literal statutory language because the loss is allowed to be taken *only* under the straddle rules and otherwise is specifically disallowed.

2007 Technical Corrections

The 2007 technical corrections legislation fixed this problem to clarify that the loss will not be permanently disallowed. Consequently, with this clarification, the identified straddle rules are now useful to ameliorate audit risk for hedges of capital assets. To take advantage of the identified straddle provision, a taxpayer first must identify a hedge as an identified straddle before the close of the day the position in the straddle is acquired. However, there are two basic limitations to the positions that may be identified: (1) to the extent provided in regulations, a position cannot have an inherent loss (*i.e.,* value is no less than basis) and (2) the positions in the straddle cannot be part of a larger straddle.

Once a straddle is identified by the taxpayer, a loss on the disposition of a position in the identified straddle is added to the basis of the offsetting positions by an amount that bears the same ratio to the loss as the unrecognized gain in the offsetting position bears to the unrecognized gain in all offsetting positions. The technical corrections added a clarification to address the situation where there may be no gain in the offsetting positions: if the application of the allocation rule would not result in an increase in basis, the basis of each of the offsetting positions in the identified straddle shall be increased in a reasonable, consistently applied manner.

Identified Straddles Versus Integrated Transactions

In certain situations, taxpayers may have a choice whether to identify a transaction as an identified straddle under section 1092(a)(2) or an integrated transaction under Treas. Reg. § 1.1275-6, or, in appropriate instances where foreign assets or liabilities are involved, under Treas. Reg. § 1.988-5. The overlap exists in the situation where the derivative is used to create a synthetic debt instrument. For example, a swap could be used to turn a floating rate debt instrument into a fixed rate debt instrument. In this case a taxpayer could identify the transaction under Treas. Reg. § 1.1275-6 as integrated resulting in a synthetic fixed rate bond or use the identified straddle rules under section 1092(a)(2). In the former situation, for tax purposes, the taxpayer would be treated as having a single debt instrument. If the taxpayer disposed of the derivative while retaining the original debt instrument, the Treas. Reg.

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§ 1.1275-6(d)(2) legging out rules would apply, causing a deemed disposition of the synthetic asset, which would result in the offsetting gain and loss being recognized currently and a basis adjustment to the continuing debt instrument. If there were unhedged embedded gain or loss in the debt instrument—as in the situation of credit risk, for example—it would be recognized in the deemed disposition. On the other hand, if the identified straddle rules were used, and the taxpayer disposed of the derivative while retaining the original debt instrument, gain, but not loss, would be recognized currently. A loss would be added to the basis of the outstanding debt instrument. Gain, on the other hand, would be recognized even though the gain hedged an offsetting loss in the debt instrument.

Because of the one-way nature of the straddle rules—in cases of overlap—it may be preferable to use the integration rules, where applicable. It should be noted that the identified straddle rule is not available in a situation to which the tax hedging rules are applicable. *E.g.,* section 1092(e) (Treas. Reg. §§ 1.1221-2 and 1.446-4, *i.e.,* certain hedges of ordinary property or ordinary obligations.)

Conclusion

The technical corrections legislation provided a much-needed solution to a significant problem for life insurance companies. With this clarification, the identified straddle rules should be considered in any situation involving a hedge of a capital asset. Preliminary indications are that life insurance companies will use the identified straddle rule extensively to avoid uncertainty and ensure that on examination the IRS will not attribute a loss on derivatives to unidentified assets, or, worse, to the entire bond portfolio. It should be particularly useful for derivatives designated as highly effective asset hedges for GAAP and statutory accounting purposes. In such cases, the identified straddle rules can ameliorate the audit risk for hedges of capital assets.

ACLI Update Column

by Mandana Parsazad

In January 2008, the American Council of Life Insurers (ACLI) had the exceptional opportunity to be informed in advance of the preliminary findings the Treasury Department (Treasury) and the Internal Revenue Service (IRS) have made in their project to improve and simplify the correction procedures for life insurance and annuity contracts that have failed the requirements of the Internal Revenue Code (the Code). In sharing their proposed course of action with the ACLI, Treasury and IRS officials noted the extraordinary coordination between the government and the life insurance industry in this project. The ACLI and its members agree—the life insurance industry viewed this project as an opportunity to brief Treasury and IRS on the practical complexities of tax compliance for life insurance and annuity contracts and is pleased that many of its concerns with existing procedures are being addressed.

Our dialogue—as well as the relief Treasury and IRS have informally outlined to us—confirm the government heard that the industry has every interest in keeping its life insurance and annuity contracts in compliance with the requirements of the Code.

This project began last year when Treasury and IRS issued Notice 2007-15 (Notice) in January 2007, seeking input on how the procedures for correcting life insurance contracts failures might be improved. The ACLI submitted comments suggesting comprehensive changes to the current procedures by which the IRS permits life insurers to correct life insurance and annuity contracts that have failed to meet the technical requirements of the Code. Specifically, we suggested:

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(1) The procedure for obtaining waivers under section 7702(f)(8) for failures of life insurance contracts to satisfy section 7702 that the Treasury and IRS determine to be "reasonable" could be streamlined and made automatic in cases where contract failures occur for reasons that the IRS has repeatedly deemed to be reasonable;

(2) Toll charges for section 7702, 7702A and section 817(h) failures could be determined more simply and in a manner that would more directly reflect the seriousness and magnitude of the errors for which correction is sought; and

(3) The closing agreement procedure for life insurance contracts that inadvertently become modified endowment contracts (MECs) would be less burdensome, without affecting the integrity of the closing agreement process, if applicants for closing agreements were required to submit substantially less information than is currently required by Rev. Proc. 2001-42.

In our subsequent meetings and submissions, we raised critical tax policy reasons for the changes we recommended and underscored the compelling non-tax reasons underlying life insurance companies' commitment towards their compliance obligations. These discussions helped inform Treasury and IRS that life insurance companies have compelling reasons to safeguard the good reputation of their life insurance and annuity products to remain competitive in the marketplace. We also highlighted that state insurance regulation, consumer lawsuits and, in the case of variable contracts, securities laws impose sanctions on companies that do not comply with the law. Our continuing open dialogue with Treasury and IRS forged a relationship of trust on this project that contributed to guidance that we expect will result in more efficient use of IRS personnel as well as life insurance and annuity contract compliance resources.

The ACLI looks forward to the release of guidance on life insurance and annuity contract corrections procedures and continuing to work cooperatively with the Treasury and IRS on similar issues in the future.