CONSTRUCTIVE SALES

8/9/2012

White Paper

Abstract: Section 1259 of the tax code governs tax treatment for constructive sales. This paper discusses the history and practical applications of these rules. Specifically, we cover how to identify constructive sales and discuss the differences that occur between 'long' and 'short' boxes. We address the similarities between cost basis adjustments for constructive sales and wash sales. We discuss the interaction of section 1259 with other sections of the tax code, including 1(h)(11) (Qualified Dividend Income), 1091 (Wash Sales) and 1092 (Straddles). We examine how to perform accurate tax analysis for constructive sales.

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INTRODUCTION

The Estée Lauder Companies are known the world over for skin care, makeup, fragrance and hair care products for men and women alike. Aside from being associated with glamorous shades of lipstick and exotic perfumes, the Lauder family is also known for its shrewd understanding and manipulation of the U.S. Tax Code. Back in 1995, when the company issued an Initial Public Offering (IPO), Estée Lauder, the family matriarch, and her son, Ronald, attempted to avoid paying a whopping $95 million in capital gains taxes on the profits they reaped when they sold company stock. How did they do this? They created a constructive sale.

Here's some background information. Normally, a loss or gain is recognized for tax purposes only when a position is closed. For a long position, this occurs when the shares are sold and for a short position, this happens when the property is delivered. This makes intuitive sense as the taxpayer needs only see tax effects when he actually disposes of his positions. So, when a taxpayer wants to lock in his profits in XYZ, but prefers not to pay taxes, here's what he could do: simply short a number of shares in XYZ equal to his long position and hold two 'open' positions (one long and one short) and therefore not recognize any gain. Because the two positions, when considered in aggregate, have a net effect of the taxpayer owning no shares, the taxpayer effectively liquidates his very profitable trade, locks in his gains and pays no taxes on it!

The tax-savvy Lauder family used this knowledge and here's what they did. When their company went public, they did not sell their own stocks but instead, borrowed company stock from other family members and sold those shares. This created what's known as a constructive sale, or a "short-versus-the-box" rule, whereby both a long and a short position are held at the same time.

It's true that the Lauder family took this tax-avoidance technique to new heights. But they were just following a current trend. During the 1990s, the use of constructive sales was widespread among hedge funds and affluent investors as a means to reduce, defer or eliminate tax liabilities. Hedge funds aggressively used constructive sales to do two

things: 1) systematically convert unrealized short-term gains into realized long-term gains, and 2) delay those gains from being realized for as long as possible.

Within two years of the Lauder transaction, which drew a great deal of negative press and ire from the IRS, the Taxpayer Relief Act of 1997 (TRA) shut down the constructive sale loophole. President Bill Clinton signed the TRA into law in August 1997. In total, the TRA resulted in no less than 800 changes to the already massive tax code. This paper focuses on the introduction of Section 1259, the new section of the tax code that specifically targets constructive sales.

In its simplest form, a constructive sale is created when a security is sold short at the same time the taxpayer owns one or more appreciated long positions in the same security. Many other combinations are possible, including short positions or substantially identical securities. Section 1259 forces the taxpayer to recognize gains as if they sold (or covered) the previously open, appreciated position. The rule also affects the holding periods involved with the transactions. This essentially prevents the taxpaying entity from getting away with the attempted gimmicks in the infamous Lauder tax-evasion case.

SECTION 2: DEFINITIONS

Box : Any time a Patriarch Security is held and another security from its constructive sale family is subsequently acquired in the opposite direction (long vs. short).

Leg-1: Any time a box is created, whichever of the two positions is created *first* is known as Leg-1.

Leg-2 : From a chronological perspective, the second position of the box.

Cost Basis Adjustment: The change to the cost basis of Leg-1 due to its participation in a constructive sale. The amount of the change is typically equal to the amount of recognized gain triggered by the constructive sale.

Patriarch Security : The security that forms the root of the Constructive Sale Family. There is only one Patriarch Security in each family.

Constructive Sale Family: This consists of a patriarch security, all other securities considered substantially identical (see Using Market Risk Concepts to Refactor Tax Shelters for a deeper discussion of substantially identical) to the patriarch security, and any other securities explicitly called out as triggering a constructive sale, such as offsetting principal notional trades. Note: If security B and security C are each in the Constructive Sale Family of Patriarch security A, security B and security C are not necessarily in each other's core family! A Constructive Sale Family does not have transitive properties. In its simplest form, a Constructive Sale Family consists of only a patriarch, or single security.

Secondary Security: All the securities in a Constructive Sale Family other than the Patriarch Security.

Sublots: A sublot occurs when a tax lot is broken into smaller units by a tax adjustment that affects some but not all of the shares. Two examples that can cause this are Wash Sales and Constructive Sales.

SECTION 3: CONSTRUCTIVE SALE PROCESSING

Any auditor or software system must use an exact and consistent process when calculating adjustments for constructive sales. The IRS can be very tolerant of mistakes provided the process is unbiased and consistently applied. This section walks through the elements integral to a consistent process for constructive sale tax analysis.

Section 3A: Family Grouping

First, one applies the rules from above to determine all necessary Constructive Sale Families. Any security that has been held at any point during the current analysis year counts as a patriarch security. Each patriarch security and its related secondary securities together form a 'Constructive Sale Family.' Note that each security is the Patriarch Security in exactly one Constructive Sale Family, but can appear in many families as a Secondary Security.

Section 3B: Box Identification

Next, one traverses the list of all transactions during the analysis period. For each transaction, one must determine if that transaction creates a constructive sale on another position where the other position's security is the patriarch of a family that includes the new transaction. For this part of the analysis, we only consider transactions that open a position. These transactions of interest are potentially "Leg-2." If the offsetting position is an appreciated position (after fully adjusting for all prior cost basis events), then a constructive sale could have been created.

When multiple candidates can be the "Leg-1," the taxpayer has some discretion. He is not[1] allowed to select a Leg-1 with zero or negative gain, but all other candidates are eligible and the taxpayer typically would pick whichever one results in the most favorable tax outcome. However, the algorithm used by the taxpayer must correspond to the same mechanism by which they normally select lots for retirement, per 1259(e)(3).

Section 3C: Exceptions

Section 1259 allows for some exceptions. **One** major exception, 1259(c)(3)(A), applies when **all** of the following conditions exist for a pair of trades:

1. The transaction that would have created the constructive sale is closed before the end of the 30th day after the end of the tax year.

2. The appreciated financial position was held throughout the 60-day period beginning on the date on which the transaction closed.

3. The risk of loss was not reduced at any time during that 60-day period by holding certain other positions.

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[1] KPMG, which provides audit, tax, and advisory services, offers a dissenting opinion in "Modern Taxation of Short Against the Box Transactions"
http://www.us.kpmg.com/microsite/taxnewsflash/2010/Sep/Modern%20Taxation%20of%20Short%20Against%20the%20Box%20Transactions.pdf

Section 1259(c)(3)(B), further clarified by Revenue Ruling 2003-1, allows 1259(c)(3)(A) to apply recursively. This means an investor can enter into one or more short-term hedges on an appreciated position within a nearly 13-month window (January 1 of the current tax year to January 30 of the next year, for an investor using calendar years), as long as these hedges are also closed by January 30 of the next year and the investor subsequently remains un-hedged continuously for at least 60 days.

A few other notable exceptions include certain debt instruments, marked-to-market securities, and specific cases of non-traded properties. In addition, Revenue Ruling 2003-07 establishes that a prepaid variable forward does not constitute a constructive sale. Another major exception is when the underlying corporations for the patriarch and the secondary securities are merged through a corporate action after both positions have been established.

There are certain instances when a literal reading of section 1259 differs from a practitioners' interpretation. Case in point: when multiple Leg-2s map to the same Leg-1. In the simple case where a taxpayer buys 100 shares of XYZ and soon after shorts 100 shares of XYZ *twice* at increasing prices, creating one long and two short lots all of the same size (100 shares), we have a conundrum. Based on a literal reading, the tax code would dictate that both shorts can create constructive sales, assuming the long lot has an appreciated value. However, most practitioners will not count the second short as a constructive sale because the first constructive sale from a philosophical perspective already eliminated the long position. Similarly, if a position was Leg-2 of a constructive sale, there is nothing in section 1259 that would prevent it from being Leg-1 of another constructive sale. Many tax professionals and compliance officers contend that the IRS would never enforce this interpretation of the code.

Section 6 below briefly addresses the ambiguity around collars, synthetic positions constructed with options and offers some critiques of Section 1259.

Section 3D: Gain Realization and Basis Adjustment

A constructive sale forces the taxpayer to recognize a gain at the time of its creation. The gain must be taken into account for the tax year in which it occurs. In the common case where Leg-2 is a short, the date of the constructive sale is the trade date, **not** the settlement

date. When realizing the gain, the investor adjusts the tax basis of Leg-1, thus avoiding having to pay multiple instances of tax on its gain. This section describes the rules for when the taxpayer is forced to assume the gain, when he may use the loss and how to determine whether the gains and loss are short term or long term.

The gain on a constructive sale is taken on the date that Leg-2 is executed. The amount of the gain is set to be the amount of unrecognized gain on Leg-1, using a consistent mechanism to determine the amount of appreciation on this lot. If multiple lots are available to be selected as Leg-1, the taxpayer may choose amongst these available *appreciated* lots, applying a consistent process as we describe in Section 3B. Typically, the lot with the highest cost basis that generates the smallest amount of gain is chosen. To calculate the appreciation (unrecognized gain) of the lot, the fair market value of the security must be determined. This is typically done by using the price of the target security on the close of its primary market on the date on which Leg-2 is *traded* (not settled). If not enough shares are available in a single lot, multiple lots must be used if available. The amount of the gain is calculated based on the difference between the tax-adjusted cost basis of Leg-1 and the value of the position on the date of the constructive sale.

The amount of this difference is then applied as a *cost basis adjustment* to Leg-1. If the constructive sale is smaller than the size of Leg-1, then two *sublot*s are created and the cost basis adjustment is applied to one of the sublots. This cost basis adjustment therefore allows the gain to be offset when Leg-1 is eventually retired.

Section 3E: Holding Period Adjustments

Constructive sales affect the tax lot acquisition date and therefore alter the holding period of the Leg-1 tax lot. In the case where Leg-1 lot had been held for sufficient time such that it would qualify as long-term on the execution date of Leg-2, then the resulting gain from the constructive sale is considered long term. In the case where Leg-1 would not qualify as long-term on the execution date of Leg-2, then the resulting gain from the constructive sale is considered short term

In all cases, the tax date of Leg-1 is adjusted to the date of the constructive sale. That is, a constructive sale completely resets the holding period in all cases. If sublots are created, the sublots may then have both different cost bases and different holding periods.

Section 3F: Stickiness of Leg-2

Anytime Leg-1 of a Constructive Sale is closed, while Leg-2 remains open, it is possible that another constructive sale is created. The taxpayer has to re-evaluate whether another Leg-1 can be found, as if Leg-2 has been freshly entered into on this date.

SECTION 4: INTERACTIONS WITH OTHER TAX RULES

Section 4A: Wash Sales

Wash sales also create cost basis adjustments to open lots and can interact with constructive sales in multiple ways. Below are the two most obvious cases.

1. If a wash sale precedes a constructive sale, the cost basis of replacement lots can make these open lots ineligible for selection as Leg-1 in a constructive sale. As noted in Section (3D), only lots with an appreciated tax-adjusted value may be selected as Leg-1. If the cost basis of a given lot has been lifted as a result of that lot serving as a replacement lot in a wash sale, this lot may no longer show an *appreciated* value. The taxpayer either selects a different lot as Leg-1 or can even possibly avoid having to take a constructive sale at all if no other appreciated lot is available. Alternatively, the wash sale basis adjustment may reduce the appreciated value, thus at least blunting the impact of the constructive sale.

2. Constructive sales alter the cost basis of a given lot that has served as Leg-1 in a constructive sale. This in turn can create a scenario wherein the lot is eventually retired; the lot may show a tax loss, even if it has an economic gain. This means that the lot retirement can now potentially qualify as a wash sale if a legitimate replacement lot can be found. If so, that loss is now disallowed. Or, if a lot already qualified as a

wash sale, the adjustment from the constructive sale can exacerbate the disallowed loss.

Section 4B: Straddles

In general, most constructive sales are also considered straddles. But not every straddle is a constructive sale. We will discuss several major differences here. First, the language in section (1092) for straddles uses the term "offsetting" to determine when a second position induces a straddle. Constructive sales require a closer match in securities or "substantially identical" securities. The difference between these two concepts is covered in Using Market Risk Concepts to Refactor Tax Shelters. Also, a constructive sale requires Leg-1 to have an appreciated financial position whereas a straddle has no such requirement. A third major difference occurs when two debt instruments in a boxed position form a straddle, but not a constructive sale, because certain debt instruments are explicitly excluded even if Leg-1 has an appreciated financial position. There are other differences as well (refer to Section 3C above).

In the case where the situation results in both a constructive sale and a basic straddle, the following thinking should be employed:

1. The constructive sale occurs immediately. The gain on Leg-1 must be taken.
2. After the constructive sale occurs, check to see if either lot is retired for a loss according to the tax rules.
3. At the end of tax year processing, if (2) occurs and the surviving lot (or its successors or their offsets) are still open and showing a ***tax-adjusted***[2] unrecognized gain, then the loss is disallowed for the current tax year. See Tax Implications of Straddles for a discussion on basic straddle processing.

It is important to note that every constructive sale generates a cost basis adjustment on Leg-1 and this will determine the tax-adjusted unrealized gain/loss at year end. This has the

[2] This is one of the many reasons a practitioner must perform both constructive sales analysis and straddles analysis contemporaneously. Otherwise, the auditor is doing their client a major disservice in missing opportunities to reduce the taxpayer's liability.

effect that the amount of loss disallowed in a basic straddle may be reduced or even eliminated altogether.

Lastly, since basic straddles do *not* create cost basis adjustments to their surviving positions and successor positions, then disallowed losses due to straddles do *not* have a ripple effect on later tax events. (A basic straddle results in deferred loss, rather than cost basis adjustment.)

Section 4C: Qualified Dividends (QDI)

There are three primary interactions of constructive sales with QDI.

1. If the box that engendered the constructive sale is still open at the point the long security goes ex-dividend, the dividend is not qualified due to section 1(h)(11)(B)(iii)(II), but only when the taxpayer is obligated to make an equivalent dividend payment due to holding the short position.

2. If the short position is covered prior to ex-date, the dividend might be qualified depending on whether the long position is open 61 days starting from the date which the short position is covered.

3. If the constructive sale occurs after the ex-date, then the dividend qualifies only if the holding period had already qualified prior to the constructive sale.

SECTION 5: EXAMPLES

Example 1 – Long Constructive Sale

Activity: The taxpayer buys a single share of stock ABC on January 3rd of 2011 for $100. On December 30th, the taxpayer shorts one share of stock ABC at $125. The short does not settle until sometime in January of 2012.

Result: The taxpayer is liable for a short term capital gain of $25 achieved on December 30th due to a constructive sale created on that date. The cost basis adjustment is $25, meaning the cost basis of the long share purchased on January 3rd is increased from $100 to $125 and the apparent tax date of this position is reset to December 30th. But this configuration also forms a basic straddle, so the day-counter for the holding period is suspended while the basic straddle is in place. See Tax Implications of Straddles for further discussion on this topic.

Example 2 – Short Constructive Sale

Activity: The taxpayer shorts a single share of stock ABC on January 3rd of 2011 for $100. On February 15th, the taxpayer buys (long) one share of stock ABC at $80. Both positions remain open at year end, December 31st 2011.

Result: The taxpayer is liable for a short term capital gain of $20 achieved on February 15th due to a constructive sale created on that date and the tax basis of the January 3rd short is adjusted to $80. Per Example 1, this configuration also forms a basic straddle.

Example 3 – Long Partial Constructive Sale

Activity: The taxpayer buys two shares of stock ABC on January 3rd of 2011 for $100 each. On February 15th, the taxpayer shorts one share of stock ABC at $125. Both positions remain open at year end, December 31st 2011.

Result: The taxpayer is liable for a short term capital gain of $25 achieved on February 15th due to the creation of a constructive sale on that date. This represents half of the unrecognized gain on the ABC position on the day the short was executed.

Example 4 – Long Partial Constructive Sale with Closeout of Leg-1

Activity: The taxpayer buys two shares of stock ABC on September 1st of 2010 for $100 each. On February 15th of 2011, the taxpayer shorts one share of stock ABC at $125. On October 1st of 2011, the taxpayer sells one of the shares from the September 1st purchase at $130. The other positions remain open at year end, December 31st 2011.

Result: First, the taxpayer breaks the original September 1st buy into 2 sublots of 1 share each. The short on February 15th is a Leg-2. Now in processing the October 1st sell, the taxpayer has two options: a more-tax option and a less-tax option.

More-tax option: Sell the Leg-1 on October 1st. On October 1st, the taxpayer sells the sublot that he identifies as Leg-1 of the constructive sale created on February 15. This Leg-1 has a previously recognized short-term gain of $25, with a previously adjusted basis of $125 and an apparent tax date of February 15th. (However, per the straddle rules, the holding period of the long position does not begin until the short position is disposed of. See Tax Implications of Straddles)

When Leg-1is sold on October 1st, the sale generates an additional short-term gain of $5. Additionally, Leg-2 (the short from February 15) still remains and now causes a constructive sale of the unsold sublot. This new Leg-1 has an adjusted basis of $130 and a tax date of October 1st, with a realized short-term gain of $30. In sum, the taxpayer has $60 of short-term gain, and a long position with an apparent date of October 1st of 2011. (However per the straddle rules, the holding period of the long position does not begin until the short position is disposed of. See Tax Implications of Straddles)

Less-tax option: Do not sell the Leg-1 on October 1st t. On October 1st, the taxpayer sells the sublot that is not part of the constructive sale created on February 15. That Leg-1, which has an adjusted basis of $125 and a tax date of February 15th, has a previously recognized short-term gain of $25. On October 1st, the unadjusted sublot is sold, realizing an apparent long-term gain of $30. In sum, the taxpayer has $25 short-term gain and an apparent $30 long-term gain, and a long position dated February 15th of 2011. However, due to straddle rules, the long-term is reclassified to short-term. See Tax Implications of Straddles.

Example 4 illustrates how important it is for the taxpayer to decide which sublot should be sold after a constructive sale on part of a lot.

Example 5 – Substantially Identical

Activity: The taxpayer buys 207 shares of stock ZZ on January 3rd of 2011 for $10 each. On February 15th, the taxpayer shorts one share of convertible preferred ZZTHP at $3000. On February 15th, ZZ shares close at $14.50 each. Both positions remain open at year end, December 31st 2011.

Result: In this example, ZZ is the patriarch security and ZZTHP is a secondary security in ZZ's Constructive Sale Family. Per revenue ruling 77-201, convertible preferred shares can be substantially identical to the underlying common stock at the appropriate conversion ratio assuming certain conditions are met – which we will assume have been met for this example. The single share of ZZTHP is convertible into 206.6116 shares of ZZ. This means that the unrealized gain of $931.50 is subject to constructive sales rules. The conversion ratio is 206.6116. Therefore, 99.8124% of the unrealized gain on February 15th must be realized. The taxpayer is liable for a short term capital gain of $929.75 achieved on February 15th due to the creation of a constructive sale on that date.

Example 6 – QDI Interaction

Activity: The taxpayer buys three shares of stock DEF on January 1st, 2010. On July 5, 2011, the taxpayer shorts a single share of stock DEF, creating a constructive sale due to the appreciation of the position acquired on January 1st. On August 1st, 2011 the taxpayer covers his short position on DEF. On August 2nd, DEF has an ex-dividend event that produces a dividend of $1 per share. The taxpayer sells off all three shares on September 1st.

Result: The three share position of DEF must be considered to exist as two sublots, one consisting of a single share, which serves as Leg-1 for the box created by the short on July 5,

and the other consisting of two shares. The two-share sublot can produce qualified dividends and the Leg-1 cannot and here is why:

The qualification period starts on 8/1/2011 – 60 days = 6/3/2011 and completes on 6/3/2011 + 121 days = 10/2/2011. During this window, the Leg-1 was held for 32 days prior to the box (June 3 to July 5) and for 31 days after the box (August 1 to September 1). Unfortunately, the 32 days prior to the box is ignored, because the box resulted in a constructive sale. The post-box 32 days falls short of the 60-day cut off.

Therefore, the $3 received in dividends must be subdivided as follows: $2, which is a qualified dividend, and $1, which is ordinary income. Although a straddle was also created due to the short position, because the long position was considered to be long-term prior to the straddle, the holding period of the two-share lot remains unaffected.

Example 7 – Wash Sale Preventing a Constructive Sale

Activity: The taxpayer buys a single share of GHI on January 1st of 2011 at $100. On January 2nd of 2011, the taxpayer sells this share for $90, realizing a short-term loss of $10. On January 3rd of 2011, the taxpayer buys a new share of GHI at $95. On July 5th, 2011, the taxpayer shorts a single share of GHI at $100, $5 higher than the purchase price of the single share on January 3rd.

Result: The January 2nd sale qualified as a wash sale due to the subsequent purchase of a new share on January 3rd. This disallowed loss triggered a cost basis adjustment on the January 3rd lot changing its cost basis from $95 to $105. Therefore, when the short occurs on July 5th, the January 3rd lot is not an *appreciated* financial position for tax purposes. Selling it would yield a taxable loss. Therefore, there is no constructive sale.

Example 8 – Constructive Sale Enabling a Wash Sale

Activity: The taxpayer buys a single share of GHI on January 1st of 2011 at $100. On February 2nd of 2011, the taxpayer shorts a share of GHI for $110. On March 3rd of 2011, the taxpayer sells the share of GHI at $105. On March 5th of 2011, the taxpayer buys a new share of GHI at $113.

Result: The February 2nd short creates a constructive sale, realizing a $10 gain. The January 1st buy has its cost basis adjusted to $110. Consequently, the subsequent March 3rd sell is a wash sale due to the subsequent March 5th buy. The $5 loss is disallowed and instead the March 5th buy has its cost basis adjusted to $118.

As this example shows, generally, a wash sale reduces the likelihood of a constructive sale but a constructive sale increases the likelihood of a wash sale.

Example 9 – Straddle Interaction

Activity: The taxpayer buys a single share of stock ABC on January 3rd of 2011 for $100. On February 15th, the taxpayer shorts one share of stock ABC at $125. On December 27th, the taxpayer covers the short position at $130, settling on December 30th. The long position is held open until year end. On December 31st, 2011 ABC closes on the New York Stock Exchange (NYSE) at $128. The NYSE is the primary exchange on which ABC is listed. Assume the long position is closed sometime in January 2012, so the 1259(c)(3)(A) exception does not apply.

Result: The taxpayer is liable for a short-term capital gain of $25 achieved on February 15th due to a constructive sale created on that date. In addition, the taxpayer has created a basic straddle. The realized loss on the short-cover from December 30th is therefore subject to disallowance. The open lot has an adjusted cost basis of $125 due to the constructive sale and therefore has an appreciated unrealized gain of exactly $3 on December 31st. Therefore, up to $3 of all associated straddle losses is disallowed. Since the realized losses exceeded this amount, all $3 is disallowed. This causes $3 of the $5 loss from December 30th to be

disallowed. This $3 can be re-allowed in a future tax year, subject to the application of the straddle laws in that year. See Tax Implications of Straddles to get the full rules for this scenario.

Example 10 – Same-Year Carryover

Activity: The taxpayer buys a single share of GHI on January 1st of 2011 at $100. On February 2nd of 2011, the taxpayer shorts a share of GHI for $110. On March 3rd of 2011, the taxpayer covers the short at $110. On March 5th of 2011, the taxpayer sells the share for $98.

Result: The February 2nd constructive sale causes a $10 realized gain. The original buy is adjusted to have a cost basis of $110 with a tax date of February 2nd. The March 3rd cover has no tax impact. The March 5th sell results in a realized loss of $12. In sum, the taxpayer has a $2 loss.

The purpose of this example is to show that the cost basis adjustment from a constructive sale is used immediately, as is the case for a wash sale. This is distinctly different from a straddle, where a disallowed loss becomes a deferred loss that can only be used in a subsequent tax year (i.e., not this year).

SECTION 6: AMBIGUITIES AND CRITIQUE

Section 1259 has elicited some unfavorable reactions from tax professionals and compliance officers, who complain that the rulings contain a number of shortcomings that make both doing business compliance challenging. These include the following:

1. It reduces the hedging ability of an investor. While the investor can hedge within a 13-month period, he must remain exposed afterward for 60 days continuously to avoid a constructive sale. Moreover, this 13-month period is rigidly set to be January 1 to

January 31 of next year for investors using the calendar year as tax year.

2. It reduces investor flexibility. Prior to the advent of Section 1259, an investor could short against an appreciated position and use the proceeds to diversify into other positions without paying a tax on the gain. Under Section 1259, this diversification is made harder because the investor now must first pay tax on that gain.

3. It is not always easy for an investor to gain access to the proceeds of a short sale. So an investor may lack the liquidity to pay the tax on realized gains forced by constructive sales.

4. Lot selection for constructive sales must be "made in the same manner as actual sales;" however, it is unclear what this means when specific identification is normally used.

5. Final determination of whether a potential constructive sale meets the 1259(c)(3) exception may not be able to be made until 90 days after the end of the year, which is after the March 15 deadline for the filing of corporate tax returns

6. Section 1259 has significant ambiguities, and the IRS has not issued regulations as congress provided for in 1259(c)(1)(E). According to the 1997 Blue Book[3], Congress expected the U.S. Treasury to issue regulations on these, and states "The Congress intended that the Treasury regulations with respect to collars will be applied prospectively, except in cases to prevent abuse." For example, these regulations *may* consider sophisticated trades like a collar (formed by simultaneously trading a put and a call on the same underlying) or a synthetic to trigger a constructive sale.

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[3] The Blue Book is issued annually by the Joint Committee on Taxation to provide an explanation of tax legislation enacted in that year. The 1997 Blue Book raises the issue of a "collar with a width of 15%" as something the IRS needs to issue an official ruling. Even after 15 years since issuing the 1997 Blue Book, this has not yet been codified.

SUMMARY

If the Lauder's astute estate planning helped catalyze the creation of the law on constructive sales, this would be a rare instance where High Fashion had such a huge impact on High Finance. Section 1259 accelerates the recognition of gains and hence increases the associated tax liabilities. The law is fairly broad in what constitutes a constructive sale, and leaves some areas of ambiguity that are still not fully clarified. But once a constructive sale has been identified, the process of making the adjustments and realizing the gain is straightforward. Further complexities arise based on the interplay of constructive sales with wash sales, straddles, and qualified dividend income.

This white paper is part of a series that provides tips and analyzes issues related to performing tax analyses on securities transactions. Launched in July 2011, G2's white paper series examines the challenges firms encounter when tackling the complex process of identifying and analyzing wash sales and other tax events. For more information or additional free resources on this and related topics, please visit G2's **Tax Analysis for Securities Transactions Resource Page** at http://g2ft.com/taxanalysisforsecuritiestransactionsresources.html

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