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Internal Revenue Service

Department of the Treasury

UIL Nos.: 263.21-00, 1092.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:
CC:DOM:FI&P:3/PLR-103110-98
Date:
February 3, 1999

Legend:

Taxpayer =

Corporation =

Lender =

Agent =

Account 1 =
Account 2 =

Date 1 =
Date 2 =
Date 3 =
Date 4 =

Dollars 1 =

Number 1 =
Number 2 =

Percent 1 =
Percent 2 =

Dear

This letter responds to a letter received February 3, 1998, as revised in a letter received February 2, 1999, requesting the following rulings:

(1) That § 263(g) will not disallow any deductions for interest on certain loans because of a costless collar on Corporation stock;

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(2) Alternatively, that § 263(g) will disallow deductions for only a portion of the interest on the loans; and

(3) That stock identification rules similar to those of § 1.1012-1(c)(3) or § 1.1092(b)-3T(d) will be available to identify that the Corporation stock used as collateral for the loans is distinct from the Corporation stock subject to the costless collar.

FACTS

Taxpayer and a counterparty will enter into a "costless collar" with respect to a specified number of shares of Corporation stock. Taxpayer will purchase a cash-settlement put option from the counterparty and sell a cash-settlement call option to the counterparty. The put option and the call option will have the same trade dates and the same maturity dates. If the price of Corporation stock is less than the exercise price of the put option at maturity, the counterparty will pay to Taxpayer an amount equal to the product of that difference times the specified number of shares. If the price of Corporation stock is greater than the exercise price of the call option at maturity, Taxpayer will pay to the counterparty an amount equal to the product of that difference times the specified number of shares. The exercise prices of the two options will be set so that the premiums on the two options are substantially equal. The exercise price of the call option will be greater than the exercise price of the put option.

Taxpayer entered into a margin loan agreement with Lender on Date 1. Under the agreement, Taxpayer can borrow a maximum of Dollars 1. The loan is collateralized with Number 1 shares of Taxpayer's Corporation stock. On Date 2, certificates representing Number 1 shares of Corporation stock were transferred from Taxpayer's Account 1 with Agent to Account 2 with Agent. Account 2 is designated as an account for Taxpayer's collateral for Lender. A list of the certificates, share numbers, and issue dates is included in an attachment.

Taxpayer might enter into additional loan agreements collateralized with Corporation stock in the future. The existing loan is, and any future loans collateralized with Taxpayer's Corporation stock will be, unrelated to the costless collar. The number of shares of Corporation stock owned by Taxpayer exceeds the sum of the number of shares used as collateral for the loans and the number of shares specified in the costless collar.

Corporation's stock is publicly traded. As of Date 3, Taxpayer owned Number 2 shares of Corporation stock. As of Date 4, Taxpayer owned approximately Percent 1 of the voting power of Corporation and approximately Percent 2 of its stock.

APPLICABLE LAW

Section 263(g) provides that no deduction shall be allowed for interest and carrying charges properly allocable to personal property that is part of a straddle. (Any amount not allowed as a deduction because of § 263(g) is chargeable to the capital account of the personal property to which it relates.) Section 263(g) was added to the Code by the Economic Recovery Tax Act of 1981.

Section 1092(c)(1) defines "straddle" as offsetting positions with respect to personal property.

Section 1092(d)(1) defines "personal property" as any personal property of a type that is actively traded. Section 1092(d)(3)(A) provides that "personal property" generally does not include stock. Section 1092(d)(3)(B)(i)(I) provides an exception to the general rule of § 1092(d)(3)(A) for stock that is part of a straddle at least one of the offsetting positions of which is an option with respect to such stock (or substantially identical stock or securities).

Section 1092(d)(2) defines "position" as an interest in personal property.

Section 1092(c)(2)(A) provides that a taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding one or more other positions with respect to personal property.

Section 1092(c)(2)(B) recognizes that one or more positions may offset only a portion of one or more other positions and directs the Secretary to issue regulations that prescribe the method for determining the portion of such other positions that will be taken into account. The Secretary has not yet issued such regulations.

Section 1092(c)(3)(A)(i) provides that two or more positions shall be presumed to be offsetting if the positions are in the same personal property (whether established in such property or a contract for such property).

Section 263(g)(2) defines "interest and carrying charges" as the excess of the sum described in § 263(g)(2)(A) over the sum described in § 263(g)(2)(B). The first summand of the sum described in § 263(g)(2)(A) is "interest on indebtedness incurred or continued to purchase or carry the personal property."

There is no direct authority interpreting the phrase "indebtedness incurred or continued to purchase or carry" in § 263(g). However, the phrase also occurs in § 265(a)(2), as well as several other Code sections. Section 265(a)(2) provides that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. (Section 265(a)(2) was redesignated from § 265(2) by the Tax Reform Act of 1986.) Authorities under § 265(a)(2) are not controlling for purposes of § 263(g), but may provide useful guidance in the absence of any direct authority under § 263(g).

Rev. Proc. 98-3, 1998-1 I.R.B. 100, provides in § 4.01(20) that rulings or determination letters will not ordinarily be issued on the issue whether, for purposes of § 265(a)(2), indebtedness is incurred or continued to purchase or carry tax-exempt obligations.

Section 1.1012-1(c)(2) and (3) provide rules for the adequate identification of shares of stock sold or transferred by a taxpayer. Section 1.1012-1(c)(2) provides that an adequate identification is made if certificates representing the stock are delivered to the transferee. Section 1.1012-1(c)(3)(i) provides that an adequate identification is made if stock is left in the custody of a broker or other agent, the taxpayer specifies to the broker or agent the particular stock to be sold or transferred at the time of the sale or transfer, and confirmation of the specification is set forth in a written document from the broker or agent within a reasonable time thereafter. Section 1.1012-1(c)(3)(ii) provides that an adequate identification is made if the taxpayer delivers a single stock certificate to a broker or other agent for sale of a part of the stock through the broker or agent, the taxpayer specifies to the broker or agent the particular stock to be sold or transferred at the time of delivery, and confirmation of the specification is set forth in a written document from the broker or agent within a reasonable time thereafter. Section 1.1012-1(c)(3)(ii) also provides that an adequate identification is made if the taxpayer sells or transfers part of the stock represented by a single certificate directly to the purchaser or transferee and the taxpayer maintains a written record of the particular stock that he intended to sell or transfer.

Section 1.1092(b)-3T(d) provides requirements and methods for the identification of positions that are part of a § 1092(b)(2) identified mixed straddle. Section 1.1092(b)-3T(d)(2) provides a presumption that the taxpayer has identified a § 1092(b)(2) identified mixed straddle by the time required if the taxpayer receives independent verification of the identification. Section 1.1092(b)-3T(d)(4) describes facts that constitute independent verification, including the placement of a position in a separate and designated account maintained by a broker, futures commission merchant, or similar person (§ 1.1092(b)-3T(d)(4)(i)), and written confirmation from such a person or the party from which one or more positions of the straddle are acquired, stating the date the straddle is established and identifying the other positions of the straddle (§ 1.1092(b)-3T(d)(4)(ii)).

APPLICATION OF LAW TO RULING REQUESTS

Based on the facts and representations submitted, we conclude that the two positions consisting of the put option in the costless collar and Taxpayer's Corporation stock constitute a straddle under § 1092(c)(1). We conclude similarly that the call option and Taxpayer's Corporation stock also constitute a straddle. We conclude that the options offset only a portion of that stock consisting of the number of shares specified in the costless collar because the payoff under each option is determined by that number of shares. Because the exercise price under the call option will be higher than the exercise price under the put option, it is certain that at most one of the options will be exercised at maturity. Thus, the shares that are collateral for, or otherwise identified with, the call option may also be identified with the put option.

In the absence of regulations under § 1092(c)(2)(B), we conclude that it is permissible for Taxpayer to identify which shares of Corporation stock are part of the straddles and which shares are used as collateral for the loans using appropriately modified versions of the methods of § 1.1012-1(c)(2) and (3) or § 1.1092(b)-3T(d)(4) in order to establish that the shares that are part of the collar are not used as collateral for the Loans. For either method, any timing requirements applicable to the straddles refer to the date the costless collar is established, and any timing requirements applicable to any loan refer to the date the loan is made.

The plain language of § 263(g) prevents us from ruling that § 263(g) can never apply to put-and-call collars on stock. Thus, ruling requests (1) and (2) would require that we rule on the

issue whether the loans were incurred or continued to purchase or carry the Corporation stock in the costless collar. Because the language "incurred or continued to purchase or carry" is the same as in § 265(a)(2), and the issues are similar to the issues covered by § 4.01(20) of Rev. Proc. 98-3, we decline to rule on ruling requests (1) and (2).

Except as specifically ruled on above, no opinion is expressed concerning the tax consequences of this transaction under any other provision of the Code or regulations. In particular, no opinion is expressed concerning the applicability of § 263(g) to the costless collar and the loans. No ruling was requested and none is given concerning § 1259.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
Assistant Chief Counsel
(Financial Institutions & Products)

By: Robert B. Williams
Robert B. Williams
Assistant to Chief, Branch 3

Enclosure: 6110 copy

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ATTACHMENT

Certificates representing shares of Taxpayer's Corporation stock transferred from Account 1 to Account 2 on Date 2.

Number	Shares	Issued