

Part I

Section 1259.- -Constructive Sales Treatment for Appreciated Financial Positions

(Also § 1233; 26 CFR 1.1233-1.)

Rev. Rul. 2002-44

ISSUE

If a taxpayer enters into a short sale of stock and directs its broker to purchase the stock sold short and close out the short sale, when is a gain or a loss on the short sale realized?

FACTS

Situation 1

In January of Year 1, Taxpayer T directs its broker to borrow 100 shares of XYZ stock and sell the 100 shares of XYZ stock in the market (the Short Sale). XYZ stock is traded on a registered securities exchange. T does not own any shares of XYZ stock. On December 31 of Year 1, when the value of XYZ stock has increased (and the value of T's short position has depreciated) T directs its broker to purchase 100 shares of XYZ stock to close the Short Sale. The purchased XYZ shares are delivered to the lender of the XYZ stock on January 4 of Year 2. The purchase of the XYZ stock on

December 31 of Year 1 is a regular-way sale as described in Rev. Rul. 93-84, 1993-2 C.B. 225, with December 31 of Year 1 as the trade date and January 5 of Year 2 as the settlement date.

Situation 2

The facts are the same as in Situation 1 except that the XYZ stock has depreciated in value and the Short Sale is closed out at a gain.

LAW

Section 1.1233-1(a)(1) of the Income Tax Regulations provides that, for income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale. Under § 1.1233-1(a)(4), if the short sale is made through a broker and the broker borrows property to make a delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

In the context of determining holding period, Rev. Rul. 66-97, 1966-1 C.B. 190, states that both stocks and bonds “are considered acquired or sold on the respective ‘trade dates.’”

Analogously, Rev. Rul. 93-84 holds that the year of disposition for a regular-way sale of stock traded on an established securities market is the year that includes the trade date. In Rev. Rul. 93-84, the taxpayer placed a regular-way sale order on stock with his broker on December 31, 1992, but the taxpayer did not deliver the stock certificates or receive the proceeds from the sale until January 8, 1993. The revenue ruling holds that the year of disposition and realization is 1992.

Section 1259(a)(1) provides that if there is a constructive sale of an appreciated financial position, the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale. The term “appreciated financial position” is defined in § 1259(b)(1) to include any position with respect to stock if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value. The term “position” is defined in § 1259(b)(3) to include a short sale. Pursuant to § 1259(c)(1)(D), in the case of an appreciated financial position that is a short sale, a taxpayer is treated as having made a constructive sale of the appreciated financial position if the taxpayer acquires the same or substantially identical property.

ANALYSIS

Situation 1

Pursuant to § 1.1233-1(a)(1), the Short Sale is not consummated until the XYZ stock is delivered to close the Short Sale. Although I is treated as having acquired the XYZ stock on the trade date (see Rev. Rul. 66-97; see also Rev. Rul. 93-84), the XYZ stock will not be delivered to close the Short Sale until January 5 of Year 2. Therefore, I does not realize the loss on the Short Sale until January 5 of Year 2.

Situation 2

As in Situation 1, I is treated as having acquired the XYZ stock on the trade date, December 31 of Year 1. See Rev. Rul. 66-97; see also Rev. Rul. 93-84. At that time, unlike in Situation 1, the price of XYZ stock has decreased. Therefore, the value of I's Short Sale has increased, and I holds an appreciated financial position within the meaning of § 1259(b)(1), that is, the short position. Section 1259(b)(3). Section

1259(c)(1)(D) provides that if a taxpayer holds an appreciated financial position that is a short sale, the acquisition of the same or substantially identical stock is a constructive sale transaction. Therefore, I has entered into a constructive sale transaction by acquiring the same or substantially identical stock as the stock underlying the Short Sale. Pursuant to § 1259(a)(1), I realizes gain on the Short Sale on December 31 of Year 1.

HOLDING

(1) In Situation 1, I realizes the loss on the Short Sale on January 5 of Year 2, the date the Short Sale is closed by delivery of the stock.

(2) In Situation 2, I has constructively sold the Short Sale on December 31 of Year 1. I realizes gain in Year 1 as if I had sold, assigned, or otherwise terminated the Short Sale at its fair market value on December 31 of Year 1.

DRAFTING INFORMATION

The principal author of this revenue ruling is Kate Sleeth of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Ms. Sleeth on (202) 622-3920 (not a toll-free call).