

Part I

Section 1233.— Gains and Losses from Short Sales
(Also § 1259; 26 CFR 1.1233–1.)

Rev. Rul. 2004–15

ISSUES

(1) If a taxpayer is obligated to transfer stock to a broker as a result of a short sale and borrows stock from another broker to satisfy the obligation to the first broker by having the second broker transfer the borrowed stock to the first broker, does the transfer close the short sale for purposes of § 1.1233–1(a) of the Income Tax Regulations?

(2) If a taxpayer held appreciated stock, entered into a short sale prior to June 9, 1997, of identical stock borrowed from a broker, identified the short sale and the stock as offsetting positions in accordance with the transition rule in § 1001(d)(2) of the Taxpayer Relief Act of 1997, 1997–4 (Vol. 1) C.B. 1, 121, and continues to hold the appreciated stock, does a transfer of stock borrowed from another broker to satisfy the obligation to the first broker cause the transition rule to cease to apply?

FACTS

In January 1997, Taxpayer TP owned 100 shares of XYZ stock. In May 1997, at a time when the value of the XYZ stock exceeded TP's basis in the stock, TP effected a short sale (the Short Sale) of 100 shares of XYZ stock. To do this, TP borrowed 100 shares of XYZ stock from Broker A and instructed Broker A to sell those borrowed shares on TP's behalf. Thus, as a result of the Short Sale, TP incurred an obligation to transfer 100 shares of XYZ stock to Broker A. Before September 4, 1997, in its books and records, TP clearly identified the Short Sale and the XYZ stock (which TP still owned) as offsetting positions under § 1001(d)(2) of the Taxpayer Relief Act of 1997.

In January 2004, TP decides to replace its obligation to Broker A with a substantially identical obligation to Broker B. To do so, TP arranges for Broker B to deliver 100 shares of XYZ stock to Broker A in satisfaction of TP's obligation to Broker A, and TP thus incurs an obligation to transfer 100 shares of XYZ stock to Broker B. After Broker B's transfer of 100 shares of XYZ stock to Broker A, TP continues to have the obligation to deliver 100 shares of XYZ stock, but the obligation is owed to Broker B rather than to Broker A.

TP continues to hold the XYZ stock, and TP has not satisfied its obligation to Broker B.

LAW AND ANALYSIS

(1) Section 1233

Section 1.1233-1(a)(1) provides, “For income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale.” Pursuant to § 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 general, a short sale is closed (and thus is consummated) by the transfer of property that the short seller already owns or property that the short seller purchases for the purpose of satisfying the obligation from the short sale. If, however, a taxpayer satisfies its obligation created under a short sale by transferring property borrowed from another lender, the transfer of the borrowed property does not close the short sale. In Richardson v. Commissioner, 42 B.T.A. 830, 840 (1940), aff’d, 121 F. 2d 1 (2d Cir. 1941), the taxpayer borrowed stock to sell short. With respect to a portion of the borrowed stock, the taxpayer subsequently borrowed other stock from another lender to satisfy the obligation that resulted from the original borrowing. The taxpayer later satisfied the obligation under the second borrowing by transferring shares that he purchased. The Board of Tax Appeals required the taxpayer to recognize the gain or loss in the year in which the obligation from the second borrowing was satisfied, and the Board calculated the amount of the gain or loss on the short sale by reference to the purchase price of the stock used to satisfy the second borrowing. Although the opinion does not discuss the effect of using borrowed shares to satisfy an obligation to replace other shares previously borrowed from another lender, it is implicit in the computation of gain or loss that the satisfaction was not treated as closing the short sale.

Section 1.1233-1(a) does not require a different result. When a taxpayer transfers borrowed property to satisfy its initial obligation under a short sale, the taxpayer’s short sale obligation is not “finally discharged.” Here, the obligation of TP to deliver 100 shares of XYZ stock continues to exist, and thus Broker B’s delivery of borrowed stock to Broker A on TP’s behalf does not close the Short Sale under § 1.1233-1(a).

(2) Section 1259 Transition Rule

Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer must recognize gain as if the position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. “Appreciated financial position” is defined in § 1259(b)(1) as including a position with respect to stock if there would be gain were the position sold, assigned, or otherwise terminated at its fair market value. Pursuant to § 1259(c)(1)(A), a taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer enters into a short sale of the same or substantially identical property.

Under § 1001(d)(2) of the Taxpayer Relief Act of 1997 (the transition rule), if “before June 9, 1997, the taxpayer entered into any transaction which is a constructive sale of any appreciated financial position, and . . . before the close of the 30-day period beginning on the date of the enactment of this Act [August 5, 1997] or before such later date as may be specified by the Secretary of the Treasury, such transaction and position are clearly identified in the taxpayer’s records as offsetting, such transaction and position shall not be taken into account in determining whether any other constructive sale after June 8, 1997, has occurred. The preceding sentence shall cease to apply as of the date such transaction is closed or the taxpayer ceases to hold such position.” Section 1001(d)(2) of the Taxpayer Relief Act of 1997, 1997-4 (Vol. 1) C.B. 1, 121.

In May 1997, when the value of the XYZ stock exceeded its basis, TP entered into the Short Sale. Thus, TP entered into a transaction that is described in § 1259(c)(1), but, because the Short Sale was entered into before June 9, 1997, no gain was recognized under § 1259(a)(1).

Furthermore, before the close of the 30-day period beginning on August 5, 1997, TP clearly identified the XYZ stock and the Short Sale in its books and records as offsetting positions. Thus, the XYZ stock and the Short Sale fall within the transition rule, and, until either TP ceases to hold the XYZ stock or the Short Sale is closed, neither the XYZ stock nor the Short Sale is taken into account in determining whether any constructive sale has occurred after June 8, 1997.

In January 2004, when TP replaces the obligation to Broker A with the obligation to Broker B, TP continues to hold the XYZ stock, and the Short Sale has not been closed for purposes of § 1.1233-1(a). Accordingly, the transition rule continues to apply to the Short Sale and the XYZ stock.

HOLDINGS

(1) When, as a result of the Short Sale, TP is obligated to transfer stock to Broker A and TP satisfies the obligation by causing Broker B to transfer stock that TP borrows from Broker B, the transfer of the borrowed stock does not close the Short Sale under § 1.1233-1(a).

(2) Because replacing the obligation to Broker A with the obligation to Broker B does not close the Short Sale under § 1.1233-1(a), the transfer does not cause the transition rule to cease to apply to either the Short Sale or the XYZ stock.

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).