When the IRS Prefers Not to: Why Disparate Regulatory Approaches to Similar Derivative Transactions Hurts Tax Law

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This Article examines decisions made by the Internal Revenue Service on whether to promulgate regulations pursuant to three different but related provisions of the Internal Revenue Code: sections 1259, 1260, and 871(m). This Article concludes that when there is a statutory imperative to regulate, the use of softer methods—methods other than issuing new regulations, such as creating listed transactions—has a negative effect on tax law, slowing its evolution. Further, this Article suggests that this detriment is not outweighed by the positive effect of issuing regulations—chilling aggressive transactions in the short term. While clear regulatory lines almost always invite new forms of tax planning, this Article argues that this is better than a regime where legitimate tax planners are unfairly faced with uncertainty and where enforcement against egregious abuse is often less than forthcoming.

I. Introduction

The evolution of tax law occurs in starts and fits. While Congress, the Internal Revenue Service (IRS), and the courts all play a role, the private tax bar is pivotal in pushing the boundaries and spurring legal change, even more so than in many other areas of law. When new transactions emerge, the law adapts to counter tax planning that it views as overly aggressive. Many have lamented the fact that the IRS is outgunned, and that the traditional methods of regulating have sometimes given way to using uncertainty as a weapon, enlisting third parties to...

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validate and report information, relying on non-tax legal friction to chill private tax innovation, and even adopting pro-taxpayer “customary deviations” from statutory imperatives when the task of enforcement seems unattainable.

Another soft-regulation tactic used by the IRS is creating listed transactions. Listed transactions are expressly authorized by the Internal Revenue Code (Code). Once a transaction is listed, taxpayers and tax planners face penalties if they do not report the transactions promptly to the IRS. Through notices that announce new listed transactions, the IRS can create uncertainty by requiring information reporting, which slows aggressive behavior without running the risk of bringing an action and creating bad precedent if it lost in court. As long as the lines remain obfuscated and there are information reporting requirements, the full negative effects of a listed tax strategy on revenue never materialize since most taxpayers will not engage in the practice once it is listed. While there is merit to this IRS strategy, it does come with a downside. Having fewer regulations and fewer actions brought under these regulations slows the pace at which the courts interact with the tax law, which leads to an overall slowing of the tax law’s evolution.

Some of the most important and complicated statutory provisions of the modern Code were created in direct response to court decisions, often overturning decisions where the result led to a bad policy. In other cases, the Code and the regulations have incorporated court decisions. These clarifications and changes to the tax law are then cited later by courts, leading to a beneficial cycle where effort from all three branches of government contribute to a robust and meaningful tax law.

However, there are also disadvantages to regulating. The promulgation of regulations by the IRS is often met with aggressive tax planners’ attempts to get around the new regulation. In fact, it was this fear that caused the IRS in 1983 to withdraw regulations that were proposed under § 385 that provided a much-needed distinction between debt and equity. Despite the

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5 See generally Lawrence Zelenak, Custom and the Rule of Law in the Administration of the Income Tax, 62 DUKE L.J. 829 (2012) (suggesting that the IRS’s treatment of frequent flyer miles earned by business travelers is an example of a “customary deviation”).
9 See, e.g., Treas. Reg. § 1.338(h)(10)-1(d)(5) (2017) (incorporating the facts and holding of Kass v. Comm’r, 16 T.C.M. 1035 (1957), into an example of how the continuity of interest doctrine can apply unfavorably to minority shareholders in a reorganization).
fact that § 385 was enacted in 1969 and called for the U.S. Department of the Treasury (Treasury) to proscribe such regulations as may be necessary to determine whether an interest in a corporation is to be treated as stock or debt, the IRS subsequently withdrew them on the grounds that the proposed regulations were too vague and opened up the possibility of taxpayer manipulation. Instead, for nearly fifty years since its enactment, the debt-equity distinction was shaped through case law. It was not until 2016 that the Treasury finally issued final regulations under § 385 that were more narrowly tailored to target specific taxpayer behavior, notably inversions and earnings stripping. Given this background, it is no wonder that the IRS sometimes shies away from regulating in favor of a softer approach to stopping aggressive planning.

However, when regulation is expressly called for by statute, the failure of the IRS to provide regulation can lead to taxpayer confusion and abusive transactions. This happened with § 385, and more recently, with two statutory provisions dealing with derivatives. These two provisions provide even more apt examples. The constructive sale rules of § 1259 and the constructive ownership rules of § 1260 are among those containing a statutory demand for clarifying regulations. This is noteworthy because, despite these demands, regulations have not been issued for either provision even as taxpayer abuses have been ongoing. Conversely, the dividend equivalent amount statute, § 871(m), is also concerned with the use of derivatives to avoid taxation, but it contains no similar call for regulation. However, detailed regulations have been issued for § 871(m) in response to very similar taxpayer behavior as in the §§ 1259 and 1260 contexts.

This Article examines these three statutory provisions—§§ 871(m), 1259, and 1260—in detail, and concludes that additional regulation is more fair to legitimate tax planners, better at policing aggressive tax avoidance transactions, and more beneficial to the evolution of tax law.

II. The IRS’s Failure to Heed Section 1260’s Call to Regulate Led to Hedge Fund Abuses

The IRS’s response to “basket options” and the failure of § 1260 to evolve provide...
examples of how government inaction creates uncertainty, which, in the case of § 1260, directly led to the loss of over six billion dollars in tax revenue.\textsuperscript{21} Congress enacted § 1260 in the 1990s in response to investors’ attempts “to use derivatives, including options on hedge funds, to convert short-term trading profits into long-term capital gains subject to a lower tax rate.”\textsuperscript{22} Section 1260 attacked these derivative-trading transactions by considering the owner of the derivative to be the “constructive owner” of the underlying security.\textsuperscript{23} However, while this provision demonstrated congressional intent to stop the abusive use of derivatives,\textsuperscript{24} including options, its subprovisions were drawn narrowly to stop the problematic tax schemes then under scrutiny and have not since been expanded by regulation to capture similarly abusive structures despite being statutorily authorized to do so.\textsuperscript{25}

An example of such a transaction that failed to fall within the grasp of § 1260 is the “basket option” transaction. In a basic basket option structure, a hedge fund client enters into a contract with a bank to purchase an option on the performance of an unspecified basket of assets placed in a designated account.\textsuperscript{26} The referenced account and all the securities are held in the name of the bank. The hedge fund provides a small percentage of the funds (for example, ten percent) to purchase the securities in the form of a premium on the option, and the bank provides the rest of the funds, with the hedge fund paying the bank fees for that amount. Despite the bank controlling the designated account, in most cases the bank appoints someone related to the hedge fund as an investment advisor who makes all the trading decisions. As a way for the bank to protect its downside, most of these option contracts contain a “knockout” provision, whereby if the designated account loses more than the amount of the hedge fund’s premium, the option contract would terminate. In most cases after a year, assuming the option did not terminate, the hedge fund will exercise its option at a strike price of the initial value of the securities in the basket and in return receive a cash settlement equal to the greater of zero or the reimbursement of the premium plus basket gain or less basket loss. The result of these transactions is to turn what would be short-term capital gains, due to the frequent trades the designated account engaged in, into long-term capital gains in the form of the gain from the option contract.

Given that this transaction does not fall cleanly within § 1260, the Treasury tried to police this behavior through non-binding notices and memoranda. In 2010, the IRS issued a General Legal Advice Memoranda (GLAM) arguing that the hedge fund taxpayer should be considered to “constructively own” the underlying securities.\textsuperscript{27} In 2015, the IRS issued a notice stating that basket option transactions are to be considered listed transactions and thus subject to reporting requirements.\textsuperscript{28} However, this proved to be ineffective\textsuperscript{29} since GLAMs are non-binding and the


\textsuperscript{22} Id. at 20.

\textsuperscript{23} See I.R.C. § 1260(d) (2012).


\textsuperscript{25} See I.R.C. § 1260(d)(1)(D). No regulations have been promulgated under I.R.C. § 1260(d)(1)(D).

\textsuperscript{26} See I.R.S. Gen. Couns. Mem. AM2010-005, at 2–3 (Nov. 12, 2010); Senate Report, supra note 21, at 13–16.

\textsuperscript{27} See I.R.S. Gen. Couns. Mem. AM2010-005, at 1–2, 10.


\textsuperscript{29} See Senate Report, supra note 21, at 5–6.
notice as written seems to allow taxpayers to structure transactions in a manner that avoids the narrow confines of the listed transaction as described.\textsuperscript{30}

The government’s final method of dealing with this type of transaction was to initiate a Senate investigation that culminated with the U.S. Senate Permanent Subcommittee on Investigations and the Committee on Homeland Security and Governmental Affairs issuing a report recommending that the IRS collect additional taxes from two hedge funds that engaged in transactions involving basket option structures.\textsuperscript{31} In reaching its conclusion, the report relies on § 1260, judicial doctrines such as the substance over form doctrine and the step transaction doctrine, and the 2010 GLAM.\textsuperscript{32}

Despite the fact that the government has devoted substantial resources investigating the two hedge funds and creating the report, and despite the fact that the cited transactions alone cost the government over 6.8 billion dollars of potential tax revenue,\textsuperscript{33} the IRS has not initiated any action against either of these hedge funds. This is likely because the IRS believes it will lose in litigation, given the lack of any clear statutory authority disallowing these transactions, resulting in pro-taxpayer precedent.\textsuperscript{34}

None of the rationales provided in the subcommittee report make it likely that a court would rule in favor of the IRS. As mentioned above, and laid out in the report, § 1260, despite giving the IRS authority to issue regulations on the matter, does not directly cover the case of basket options.\textsuperscript{35} While the GLAM and subcommittee report recharacterize the transaction as one where the hedge fund option holder is bearing all the risk, the reality is that the bank does bear some downside risk if all the money put into the basket by the bank is lost before the bank has the chance to sell the securities in the basket.\textsuperscript{36}

The judicial doctrine of substance over form would also not likely provide the IRS with a winning argument against a hedge fund using basket options. Despite its seemingly straightforward application to basket options, courts often do not rely on substance over form if a transaction seems authorized and there are no regulations disallowing it.\textsuperscript{37}

The net result is that, despite the notices and reports, the government does not have an actual way, short of regulations, to stop aggressive tax planners that are trying to take advantage of the ambiguity. Those that are trying to follow the law are left confused by what is and is not allowed. For example, the confusion surrounding what exactly falls under the “listed transaction”

\textsuperscript{30} See I.R.S. Notice 2015-73, 2015-46 I.R.B. 660; see also I.R.S. Notice 2015-74, 2015-46 I.R.B. 663. A taxpayer can specifically alter the structure of a transaction in order to get around the definition of “discretion” and “designee” by, for example, leasing the trading algorithm software to a separate joint venture created with the bank and hedge fund.

\textsuperscript{31} See \textit{Senate Report}, supra note 21, at 7.

\textsuperscript{32} \textit{Id.} at 20–25.

\textsuperscript{33} \textit{Id.} at 5.

\textsuperscript{34} See, e.g., \textit{infra} text accompanying notes 45–50 (discussing how the \textit{Anschutz} case led to bad precedent being set).

\textsuperscript{35} See \textit{Senate Report}, supra note 21, at 22.

\textsuperscript{36} See \textit{id.} at 3–4, 42. “Gap risk” refers to the risk borne by the bank where market conditions deteriorate so rapidly that all the premiums paid by the hedge fund are lost and the bank is unable to sell the remaining assets quickly enough to cover losses in excess of the premium.

\textsuperscript{37} See, e.g., Summa Holdings, Inc. v. Comm’r, 848 F.3d 779, 782 (6th Cir. 2017) (holding that the substance over form doctrine is inapplicable since “[f]orm is ‘substance’ when it comes to law”) (emphasis in original); Granite Trust Co. v. United States, 238 F.2d 670, 677–78 (1st Cir. 1956).
described in the notices causes risk-averse tax planners to be overly cautious. On the other hand, tax planners that have a lot to gain through aggressive tax planning, for example hedge funds, are inclined to take risks knowing well that there is little that the government will do after the fact other than issue a non-binding GLAM or report. Even if it is clear that a particular transaction falls within the description in an IRS notice, a taxpayer can avoid penalties under the regulations if contrary authority creates uncertainty about the viability of the government’s position. The result is that the current method of inaction by the IRS hurts tax planners trying to follow the law and helps those seeking to avoid it.

III. The IRS’s Failure to Regulate under Section 1259 Left Holes in the Fight Against Constructive Sales and Set Confusing Precedent in the Courts

Section 1259 provides another example of how a law designed to halt the abusive use of derivatives to avoid taxation has suffered from the lack of government clarification after its enactment. Section 1259 requires a taxpayer who has a “constructive sale of an appreciated financial position” to “recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale.”

This statute was enacted in response to the Estee Lauder short sale against the box transaction where the founder of the company was able to get cash without paying tax by borrowing shares and shorting them while still holding a huge quantity of low basis shares from the founding of the company. As long as the short remained open, no tax could be levied since the extent of gain or loss on that transaction was uncertain; but what was certain was that however much the short gained or lost, the corresponding long position would cancel it out. This minimization of economic exposure to an asset without tax is now known as a constructive sale. Section 1259(c) describes what specifically qualifies as entering a constructive sale of an appreciated financial position and, like §1260, calls for regulations barring transactions with “substantially the same effect.” However, despite this, no regulations have yet been prescribed.

Even less guidance has been given for § 1259 than for § 1260. The only major preemptive guidance from the IRS has been revenue ruling 2003-7, which states that a transaction does not count as a constructive sale when, in exchange for payment, a taxpayer agrees to transfer at a fixed date 100 shares of stock if the price per share is under $20, a number of shares worth exactly $2,000 if the price per share is between $20 and $25, and 80 shares if the price per share is greater than $25. While this provides some guidance, it does not discuss the stock’s price volatility at all, instead relying on legislative history that merely states that “a

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38 See Treas. Reg. § 1.6662-3(b)(2) (2017); Osofsky, supra note 2, at 509.
41 See I.R.C. § 1259(c)(1) (“A taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person)---(A) enters into a short sale of the same or substantially identical property, (B) enters into an offsetting notional principal contract with respect to the same or substantially identical property, (C) enters into a futures or forward contract to deliver the same or substantially identical property, (D) in the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) with respect to any property, acquires the same or substantially identical property, or (E) to the extent prescribed by the Secretary in regulations, enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.”).
forward contract that provides for the delivery of an amount of stock that is subject to ‘significant variation’ under the terms of the contract is not within the statutory definition of a forward contract.”

Both price volatility and the range of prices to which the counterparty has no economic exposure are important to a transaction like this. For example, if the price of the underlying stock in the revenue ruling had been fixed at, for instance, $22.50 for the last 10 years and had never fluctuated more than a dollar either up or down, then the transaction would look a lot more like a constructive sale for a fixed price of $2,000. Even though on paper there was “significant variation,” without examining price volatility such a forward is just as likely to be “for delivery of a substantially fixed amount of property [at] a substantially fixed price.”

The only other major development concerning how § 1259 is interpreted has been the single notable case where the IRS attempted to stop an end run around these rules, Anschutz v. Commissioner. In Anschutz, the taxpayer used a Prepaid Variable Forward Contract (PVFC) to receive money in exchange for a promise to deliver a variable number of shares of a corporation’s stock at some time in the future. By careful financial engineering, the product allowed the taxpayer to bear none of the downside risk below a set threshold while capping his upside exposure at a level only slightly higher. By limiting the exposure Anschutz had to such a narrow band, this arguably could have been caught by § 1259 had regulations been in effect. Without any, the court held that the transaction was not a constructive sale, relying on revenue ruling 2003-7’s statement that a forward for a variable number of shares between 80 and 100 was not a constructive sale.

Curiously, the court ruled in favor of the Commissioner overall on the basis of an actual sale theory under § 1001 due to a simultaneous pledge agreement where the counterparty to the PVFC got to control the stock immediately. While the facts of the case suggest that this was the right result under § 1001, it raises the question of how something could be an actual sale yet fall short of the constructive sale threshold, given that a constructive sale is supposed to be something less than an actual sale. The court may have struggled with this apparent inconsistency too, stating in its opinion that its decision on the constructive sale issue might have come out differently had regulations been issued outlining in more detail what counted as a constructive sale.

Of course, had the IRS issued regulations beforehand, then tax planners may have sidestepped them in a different way than was attempted in Anschutz. Any time a bright-line rule is advanced, it increases the ability of planners to create transactions that fall just barely on the right side of the line while still getting their desired tax advantages. But the court decision in

43 Id. (citing S. Rep. No. 33, at 125–26 (1997)).
45 Anschutz Co. v. Comm’r, 135 T.C. 78 (2010), aff’d, 664 F.3d 313 (10th Cir. 2011).
46 Id. at 81–82.
47 Id. at 87.
48 Id. at 111–13.
49 Id. at 104.
50 Id. at 111–12 (“Section 1259 does not define the terms ‘substantially fixed amount of property’ or ‘substantially fixed price[,]’ Section 1259 gives the Secretary two sources of authority for issuing regulations to carry out Congress’ intent—section 1259(c)(1)(E) and (f)—but no regulations have been issued defining either phrase.”).
Anschutz created the same result: now that there is precedent that a certain technique is not a constructive sale, it is more likely to be used by others going forward. Had regulations been in place, the court might have considered the Anschutz transaction a constructive sale. Even if it did not, having both the court opinion and the regulations would make it easier for the legislature to change the law going forward if Congress decides that the transaction should have counted as a constructive sale.

IV. Despite their Imperfections, Regulations Issued under Section 871(m) Provide a Framework that Could Benefit Sections 1260 and 1259

Derivatives have also been used to avoid § 871(m), which provides for a tax on U.S. source dividend equivalent amounts received by nonresidents.51 U.S. source dividends themselves are taxed as Fixed, Determinable, Annual, or Periodical (FDAP) income when nonresidents receive them from U.S. sources at a 30% withholding rate.52 Prior to § 871(m), however, a nonresident could get the exact same economic payout and avoid withholding on dividends by buying a derivative instead of the stock itself.53 Such a derivative would appreciate in line with the stock and give the holder gain equal to the amounts of dividends paid out as well. Then, when the derivative was sold outside the U.S., the gain from sale would be foreign source income, thus avoiding the dividend withholding tax completely.

As with §§ 1259 and 1260, § 871(m) is concerned with the use of derivatives to escape taxation.54 What is odd is that despite no statutory language inviting clarifying regulations, in the § 871(m) context the IRS has in fact regulated.55 Notably, for the first time in its history, the IRS has used the financial measurement of delta to write rules governing whether or not a transaction is in substance barred by the statute.56 However, the problem with these regulations is that they are sometimes unclear, and scholars have questioned the accuracy of the mathematics.57 The definition of delta in the regulations is correct, but an extra step appears to be added that could cause distortions in the result.58 Nevertheless, with these regulations in place, changes could be made to remedy these problems and improve the manner in which financial engineering of derivatives that too closely mirror the payout of stock ownership is restricted.

Issuing the § 871(m) regulations was sensible, but it raises the question of why the IRS would develop a regulatory tool only in this context and not employ it in others that involve essentially similar uses of derivatives like §§ 1259 and 1260. Here, perhaps the answer is that the IRS chose to regulate instead of creating listed transactions or relying on a revenue ruling because it is harder to get information reporting from nonresidents. Or it could be that § 1259 just addresses a less common situation, so the bottom line effect on revenue might be thought not to justify the time and effort of regulation. In Anschutz, that the taxpayer had just elected to

51 See Report on Proposed Regulations under Section 871(m), 2014 N.Y. ST. BAR ASS’N, TAX SEC. REP. 1340.
53 See Report on Proposed Regulations under Section 871(m), 2014 N.Y. ST. BAR ASS’N, TAX SEC. REP. 1340.
54 I.R.C. § 871(m).
56 Delta measures the degree to which the rate of change in the price of a derivative mirrors the rate of change in the price of the underlying asset it refers to. A delta of 1 means that the price of the derivative and the asset move together in uniformity.
58 Id.
become an S corporation was significant to its motivation, and the taxpayer would have had to pay corporate tax if it recognized any built-in gain on the corporate assets within 10 years after the S corporation election. But, the benefit of immediate money without taxation on an appreciated asset seems ripe for abuse in all manner of other situations too. And such an explanation does not hold at all for § 1260, which is all that stands in the way of huge tax savings by any hedge fund. It seems therefore that there is nothing special that makes § 871(m) more likely to be avoided by aggressive tax planning.

V. Conclusion

Issuing regulations to improve and clarify the Code wherever it is ambiguous would be a difficult task. There is, of course, an alternate approach: comprehensive tax reform. If many of the current distinctions between formally different but economically similar forms of income or expense were removed, much tax avoidance strategy would no longer be effective. A mark-to-market regime would also fix many of these problems; although, it would create others. These approaches, though, require unified action from Congress and a consensus on what the goals of the tax law should be. Unfortunately, such sweeping changes do not seem likely to come any time soon, especially not without intervening events that expose more clearly the weaknesses of the current system.

Thus, clear ex ante regulations are needed; implementing something less, like a general anti-abuse regulation, will have the same effect on taxpayers as any other soft mechanism for stopping abuse in that it will still create uncertainty and still not deter the most aggressive tax planners. It is possible to point to the problems in the § 871(m) regulations as evidence that when the IRS tries to use its regulatory authority, it is as likely to get things wrong as it is to get them right. But this overlooks the fact that the law can only develop when it is subjected to testing by private-party tax innovation. And even though bad regulations in full view of the legal community like the § 871(m) regulations invite tax planning, having a clear line is still better than the uncertainty prevalent in other areas of tax law such as §§ 1259 and 1260 where legitimate tax planners are potentially at risk of being caught up in an ill-defined net cast someday in the future should the IRS decide to change its approach and bring litigation.

Further, even short of comprehensive congressional tax reform, to amend an existing regulation is easier than to write one from scratch, and blatant mistakes that create loopholes are those most likely to be remedied. This is especially true when Congress has given clear statutory authority to regulate substantially similar transactions. To decline that invitation is counterproductive and leads to courts attempting to craft decisions in the face of terms without definitions, like the court in Anschutz. The IRS’s crutch of relying on other methods such as

59 I.R.C. § 1374(a) (2012).
62 See Yin, supra note 10, at 210, 230 (arguing that the uncertainty of an anti-abuse rule will likely undermine its ability to be an effective deterrent to corporate tax shelters).
listed transactions, notices, revenue rulings, and reports hurts everyone due to the lack of
guidance. While issuing regulations in response to particular transactions will result in some
aggressive tax planners finding new ways to circumvent them, it would at least guarantee a stop
to the particular action that caused its implementation, invite legitimate transactions to occur, and
allow the legal landscape of tax law to evolve.