

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to:

(Large Business & International)

from: Patrick E. White
Senior Counsel
(Financial Institutions & Products)

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

FACTS

Taxpayer, a U.S. holding company, is the common parent of an affiliated group of corporations that files a U.S. consolidated return. Taxpayer owns all of the stock of domestic corporation S. Taxpayer also directly owns a percent minority interest in a partnership (FP) organized under foreign law, of which the remaining percent is owned by a non-CFC foreign affiliate of Taxpayer.

Taxpayer, through S and FIP, undertakes a proprietary trading strategy in which S and FP enter into offsetting positions that take advantage of temporary price dislocation in ETF shares and their underlying components. The long and short ETF positions are put on and taken off quickly. S, a broker-dealer, coordinates the high frequency trading strategy.

Some positions held by FP that were offsetting positions with respect to positions held by S were identified as identified straddle positions under section 1092(a)(2)(B). Despite its percent equity position in FP, Taxpayer treated the entire amount of the net realized loss from the identified straddle positions in FP as losses allocable to Taxpayer, resulting in a substantial step up in the basis in the associated identified

straddle positions in S. As a result of claiming _____ percent of the straddle position losses of FP, Taxpayer effectively claimed tax benefits for \$ _____ of net identified straddle losses despite an actual profit from trading activities of the partnership. FP excluded the net realized losses from the partnership identified straddle positions entirely when computing the partnership's income and losses for U.S. tax purposes.¹ (It is our understanding, however, that the foreign affiliate reports its allocable _____ percent share of the partnership losses arising from the identified straddle positions on its foreign tax returns.)

Taxpayer asserts that the section 1092(d)(4)(C) attribution rule for offsetting straddle positions held through a partnership causes the total net realized losses of the partnership on such identified straddle positions to be taken into account by Taxpayer even though its economic share of such losses is limited to _____ percent. Taxpayer asserts that section 1092(d)(4)(C) provides that if any part of the gain or loss with respect to a position held by a partnership would properly be taken into account for purposes of this chapter by a taxpayer, then such position in its entirety shall be treated as held by taxpayer except to the extent otherwise provided in regulations.

For purposes of this analysis, we have assumed that the partnership losses associated with the identified straddles were bona fide losses that were otherwise sustained by FP, that the losses were not attributable to successor positions under the wash sale rules, and that the straddles were properly identified. We have also assumed, for purposes of this advice, that section 1092(a)(2) broadly permits identification of all attributed positions as identified straddle positions. However, this advice should not be read to express an opinion on any of these factual or legal points.

LAW AND ANALYSIS

Generally, the section 1092 straddle rules defer the recognition of tax losses associated with holding offsetting straddle positions. In the case of an identified straddle, section 1092(a)(2) generally creates this deferral by causing straddle losses to be embedded into the basis of the offsetting position with unrecognized gain. Taxpayers generally then obtain the benefit of those losses upon disposition of the offsetting positions.

For purposes of determining whether a taxpayer holds offsetting positions, section 1092(d)(4) attributes positions to a taxpayer held by certain related parties and flowthrough entities. Section 1092(d)(4)(C) provides that if "part or all" of the gain or loss with respect to a position held by a partnership, trust, or other entity would properly be taken into account for U.S. income tax purposes by a taxpayer, then, except to the extent otherwise provided in regulations, "such position" shall be treated as held by the taxpayer. Taxpayer relies upon this provision to argue that because it clearly takes part (*i.e.*, its _____ % allocable partnership share) of the FP's loss on straddle positions into

¹ We do not understand the justification for the U.S. partnership return not including gain or loss associated with the identified straddle positions.

account for tax purposes, it is therefore entitled to consider itself to hold the entire position for calculating its loss under the straddle rules.

Taxpayer is incorrect in this reliance. The purpose of section 1092(d)(4)(C) is to clarify that ownership of an interest held indirectly through a partnership or other flowthrough entity is a sufficient nexus to create a straddle position in a taxpayer. Neither section 1092 nor its regulations suggest that this provision redetermines the manner in which income, deduction, gain or loss from partnership positions are allocated among partners. Instead, the applicable allocation rules are those contained in subchapter K for the determination of Taxpayer's share of partnership losses. Partnerships, although not themselves subject to income tax, compute their income in the same manner as an individual, except that some partnership items, including gains and losses from sales or exchanges of capital assets, are separately stated. Sections 701 and 703. Once the taxable income of the partnership is computed at the partnership level, partners take into account their distributive share of partnership items when determining their own tax. Section 702(a). Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in Chapter 1, be determined by the partnership agreement (so long as those allocations have substantial economic effect). Section 704(b)(2). Taxpayer's flowthrough partnership loss from the straddle positions is thus limited to the amount Taxpayer is entitled to in the partnership agreement, i.e., Taxpayer's "sustained loss."

This limitation on the loss applicable to Taxpayer is further supported by the section 1092 regulations. Section 1.1092(b)-5T defines the term "loss" as "a loss otherwise allowable under section 165(a) ..." (Emphasis added). Section 1.165-1 indicates that in order to be deductible, a loss must be bona fide and actually sustained. Substance and not mere form shall govern determining a deductible loss. Section 1.165-1(b). Thus, section 1092 does not operate to create partner-level losses, as Taxpayer argues, that are not otherwise allowable.

There is no indication in the statute or regulations that section 1092 is intended to reallocate interests in a partnership so that income, deduction, gains or losses allocable among the partners under section 704 principles is reallocated under section 1092 to another partner or partners.

Finally, reading section 1092 as Taxpayer urges would be at odds with the partnership rules and business realities. Brountas v. Commissioner, 692 F.2d 152 (1982) (court unwilling to read section 636 and partnership rules to produce absurd results where section 636's aim to close one loophole would be frustrated by opening another loophole). Taxpayer's reading would suggest that the percent equity partner in FP would not obtain the benefit of the allocable share of tax losses which it had economically incurred. See section 1092(a)(2)(A)(iv).²

² Section 1092(a)(2)(A)(iv) provides that "any loss" described in section 1092(a)(2)(A)(ii) shall not otherwise be taken into account for purposes of this title.

In sum, Taxpayer's reading of section 1092 is contrary to the language of the statute, regulations and purpose of that provision. In accordance with the above analysis, Taxpayer indirectly held positions through the partnership. Section 1092(d)(4)(C) treats those positions as held for purposes of determining whether section 1092 offsetting positions exist but cannot increase the amount of a taxpayer's share of allowable losses. Here, that means that Taxpayer's section 1092(a)(2)(A)(ii) loss, to the extent applicable, is only Taxpayer's allocable share of its partnership losses from the identified straddle positions.

Except as expressly provided, no opinion is expressed or implied on any other aspect of the transactions discussed herein including on whether the transactions constituted section 1092(a)(2)(B) identified straddles. See, e.g., section 1092(a)(2)(B)(ii) and (iii).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call _____ if you have any further questions.