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MEMORANDUM

Re: TAM 200509022 – According to the Service, a Taxpayer’s Liability Can Be a Position in a Straddle

From: Peter H. Winslow and Biruta P. Kelly

Date: March 7, 2005

In TAM 200509022 the Service adopts the position that unsecured subordinate debentures issued by the taxpayer can constitute positions in a straddle with certain portfolio stock held by the taxpayer. The TAM concludes that the stock and debentures were offsetting positions because the principal the taxpayer owed on the debt was related to the value of the stock. The TAM’s conclusion is surprising for several reasons. First, a straddle consists of offsetting positions with respect to personal property, and a debt is a liability and generally not considered property. This fact is acknowledged by the Service in the TAM (“[a]lthough a debtor’s obligation on a debt instrument generally is not personal property”). Nevertheless, with little rationale, the Service ignores it. Second, even if a straddle exists, it is not clear what unrealized gain can exist in the liability that can serve to defer any losses realized on the stock. Third, it is questionable that the debenture is a position “substantially similar or related to” the stock under former section 1092(d)(3)(B)(i)(II).

In support of its conclusion that debt constitutes a position in personal property, the TAM cites section 1092(d)(7) and certain regulations under section 1275, neither of which is directly on point. Section 1092(d)(7), which provides that certain debt in nonfunctional currency can constitute a position in a straddle, exists to acknowledge that nonfunctional currency is, in fact, property. And, the regulations under section 1275 acknowledge that certain debt may constitute a straddle; they do not provide that debt instruments generally constitute personal property.

This may be an instance of “hard cases make bad law.” The Service was concerned about the tax consequences of the complicated series of transactions, which resulted in the

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taxpayer deducting interest under the contingent payment debt instrument rules at a rate higher than the Service viewed as appropriate under the circumstances. Stretching the law under section 1092 to cover the transactions was a way to disallow such deductions under section 263(g)(disallowing interest and carrying charges allocable to property that is part of a straddle). The question is, however, with the Service having stretched section 1092, whether examining agents will rely on TAM 200509022 to set up straddles in situations where they otherwise should not exist.