# Squeezing a Balloon: Potential Impact of the American Jobs Creation Act Straddle Rules on the Tax Consequences of Hedging Nonqualified Stock Options

**Congress has provided some simplification with its amendments to Section 1092, but addressing known issues regarding the identified straddle rules now generates new issues in other areas, and Treasury or the IRS will have to provide additional guidance to provide the necessary certainty.**

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The American Jobs Creation Act of 2004[1] (the "AJCA") enacted numerous changes to the Internal Revenue Code. While the AJCA's amendments to the international and deferred compensation tax rules affect a broad range of taxpayers and have garnered significant attention, Congress also included several amendments to the straddle rules of Section 1092 that affect a narrower class of taxpayers.[2]

The straddle rule amendments attempt to simplify the operation of the straddle rules, especially as they relate to "identified straddles." One amendment in particular implicates a possibility, first raised years ago, that could result in potentially significant federal income tax benefits for hedges[3] of appreciated nonqualified stock options ("NQSOs").[4] The amended identified straddle rules now require an increase in the "basis" of an identified offsetting straddle position by the amount of the identified straddle losses.[5] Under this identified straddle rule, a taxpayer who incurs a loss on a hedge of NQSOs would appear to be required to increase the "basis" of those NQSOs, which in turn would appear to reduce the ordinary income upon the exercise of

[1] PL 108-357.

[2] The amended straddle rules are described in John J. Ensminger, "New Straddle Identification Rules: Stock Exception Removed, as Jobs Creation Act Tinkers with Straddle Rules," 18 J. Tax'n F. Inst. 48 (January/February 2005). For other commentary on the amended straddle rules, see Michael Kosnitzky, "The Uncertain Repeal of the Straddle Stock Exception," 109 Tax Notes 1458 (December 12, 2005).

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[3] Except where specified, the use of the term "hedge" refers generally to the management of economic risk and does not refer to hedging within the meaning of Section 1221.

[4] See David M. Schizer, "Executives and Hedging—The Fragile Legal Foundation of Incentive Compatibility," 100 Colum. L. Rev. 440, 480 (n. 160) (2000) (discussing a similar proposed amendment to Section 1092). An analogous possibility would exist for capitalized straddle amounts under proposed regulations under Section 263(g). See Samuel J. Dimon and Michael S. Farber, "The Straddle Rules: Current Law and Recent Developments," 20 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 1205, 1267-1268 (Practicing Law Institute ("PLI") 2004); New York State Bar Association ("NYSBA"), "Report on Proposed 'Straddle' Regulations," reprinted in Daily Tax Report ("DTR") (September 14, 2001). Proposed straddle amendments were summarized in "Joint Committee Staff Looks to 'Modernize' the Straddle Rules," 15 J. Tax'n F. Inst. 44 (September/October, 2001).

[5] Section 1092(a)(2).

the NQSOs.[6] If correct, this would eliminate the character mismatch of ordinary income on the NQSOs and the capital loss typically generated by the offsetting hedge.

This article examines whether the amended identified straddle rules and Section 83, which governs the tax treatment of NQSOs, together operate in this manner. Ultimately, this article concludes that the rules probably do not provide such favorable tax results. Nevertheless, there are benefits to this inquiry because it draws attention to an ambiguity in the identified straddle rules as to how taxpayers are to take into account identified straddle losses when one of the offsetting positions is a NQSO. Overall, Congress appears to have succeeded in simplifying the application of a complicated statute, but, like squeezing a balloon, other issues can arise elsewhere. Treasury and/or IRS guidance to clarify the application of the amended identified straddle rules to hedges of NQSOs would be welcome.

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## NQSOS

**Tax Treatment.** NQSOs are options to acquire stock (other than statutory options within the meaning of Section 422) granted to an employee or an independent contractor in connection with the performance of services. The grant of NQSOs is not treated as a transfer of property to the recipient when the NQSOs do not have a "readily ascertainable fair market value" on the date of the transfer.[7] The recipient is not taxed until the exercise (or arm's-length sale or other disposition) of the NQSOs.[8] At that time, Section 83(a) or Section 83(b) applies to the transfer of the stock.[9]

Upon exercise of the NQSO, if the transferred stock is freely transferable or is not subject to a substantial risk of forfeiture,[10] the service provider recognizes income in an amount equal to the fair market value ("FMV") of the stock on the date of exercise less the "amount (if any) paid" for such stock.[11] The "amount paid" is defined in the Section 83 regulations as the "value of any money or property paid for the transfer of property to which section 83 applies...."[12] When stock is acquired pursuant to the exercise of an option, "amount paid" means "any amount paid for the grant of the option plus any amount paid as the exercise price of the option."[13] The service provider's basis in the acquired stock includes the amount paid for the stock plus any amount includible in the service provider's income.[14]

**Hedging Appreciated NQSOs.** Appreciated NQSOs, like other appreciated financial positions, can be hedged.[15]

[6] For a discussion of various aspects of hedging NQSOs, see Schizer, supra n. 4; Robert N. Gordon and Mark J. Fichtenbaum, "Hedging Appreciated Employee Stock Options: Tax, Economic and Regulatory Concerns," Derivatives Report (October 2000); S. Stacy Eastland and Jeffrey F. Daly, "Transfer and Income Tax Planning With Stock Options," 60 New York University Institute on Federal Taxation Volume 2, Chapter 31 (2002); Peter Brady and Robert N. Gordon, "Hedging Nonqualified Stock Options," 21 J. Tax'n Inv. 243 (Spring 2004) ("Brady and Gordon I"); Peter Brady and Robert N. Gordon, "Hedging Nonqualified Stock Options Revisited," 21 J. Tax'n Inv. 359 (Summer 2004) ("Brady and Gordon II"); and "Shearman & Sterling Submits Memo on Stock Option Hedging Transactions," 2005 TNT 206-35, Tax Notes Today (October 26, 2005) ("Hedge Letter").

[7] Section 83(e)(3); Regs. 1.83-7(a), -8(a)(3). Section 409A, as enacted by the AJCA, alters the tax treatment of non-qualified deferred compensation in various respects. The AJCA generally did not alter the tax consequences of the grant of NQSOs that are not in-the-money and that do not have a deferral feature other than the right to exercise the NQSO in the future. H.R. Conf. Rep. No. 108-755 (October 7, 2004), at 735.

[8] Reg. 1.83-7(a). This regulation does not apply to non-arm's length transfers of NQSOs, but Reg. 1.83-1(c) provides rules for such transfers of substantially nonvested property.

[9] A Section 83(b) election, which permits a taxpayer to include the fair market value of restricted property in income at grant, is not available for NQSOs without a readily ascertainable fair market value because Section 83 does not apply until the transfer of the property pursuant to the option. Many of the same considerations that apply in hedging NQSOs also apply to restricted stock, but a Section 83(b) election, which can eliminate the capital loss-ordinary income mismatch, is available for this type of property. See Schizer, supra n. 4, at 493-495.

[10] See Reg. 1.83-3(b), (c) and (d) for regulatory rules on substantially vested and nonvested property, substantial risk of forfeiture and transferability.

[11] Section 83(a). Income from the exercise of NQSOs is ordinary in nature and is taxable to individuals at the graduated income tax rates of Section 1. Employment taxes apply upon exercise of the NQSO. See, e.g., Rev. Rul. 2004-60, 2004-24 IRB 1051 (describing employment tax consequences in connection with divorce-related transfer of NQSOs).

[12] Reg. 1.83-3(g).

[13] Reg. 1.83-3(g).

[14] Reg. 1.83-4(b)(1) (discussing calculation of basis in acquired substantially nonvested property, which also includes adjustments under Sections 1015 and 1016).

[15] Hedging NQSO's also has non-tax complications. An

The service provider takes a short position and a counterparty (typically, a financial institution) takes a long position with respect to the NQSOs.[16] The hedge can be effectuated through a number of different transactions, including:

1. A collar.
2. An option or options.
3. A variable delivery forward contract.
4. A notional principal contract.[17]

Hedging NQSOs using certain of these financial transactions can give rise to unfavorable federal income tax consequences, including triggering the straddle rules of Section 1092 that are described in greater detail below.

*Hedging Appreciated NQSOs with Collars, Options, or Forwards: Character Mismatch.* NQSOs can be effectively hedged from a pre-tax economic perspective by using collars, options, or variable delivery forward contracts. The service provider's "short" position under the collar, option, or forward contract hedges the "long" exposure to the stock underlying the NQSOs. In order to pay for the protection from downside risk, the service provider may sell off a portion of the potential upside reward (e.g., the cost of the "put" option inherent in a collar is offset by the sale proceeds of the inherent "call" option).[18] This can result in gain or loss on the hedge, which offsets, in whole or in part, loss or gain on the NQSOs.

*Example 1.* On January 1, 2006, Employee A is granted as compensation 30,000 NQSOs expiring in one year for Company B stock, which is currently trading at $80 per share. The exercise price of the NQSOs is $80 (equal to the FMV of B stock on the date of grant). On June 1, 2006, when B stock is trading at $100 per share, A enters into a zero-cost collar (requiring no net up-front premium) with Counterparty C. Under the collar A can sell C 30,000 shares of B stock on December 31, 2006 for $100 per share and C can acquire 30,000 shares of B stock from A for $115 per share. Each party has the right to cash settle the collar. Upon exercise of the NQSOs, the B shares will be freely transferable and not subject to a substantial risk of forfeiture. At maturity of the collar, A exercises the NQSOs.

**NQSOs can be effectively hedged from a pre-tax economic perspective by using collars, options, or variable delivery forward contracts.**

*(a)* If B stock decreased in value to $90 per share at maturity, then A buys 30,000 shares of B stock worth $2.7 million for the $2.4 million exercise price and has compensation income of $300,000 (i.e., $2.7 million FMV less $2.4 million exercise price). A exercises the "put" option inherent in the collar. A delivers to C 30,000 shares of B stock ($2.7 million FMV) in exchange for a payment of $3 million (30,000 shares x $100 per share collar exercise price). A has a gain of $300,000 on the collar ($3 million pay-

employee may be restricted in his ability to pledge NQSOs to the counterparty as collateral. See Brady and Gordon I, supra n. 6, at 245. There are also limitations related to the size of the hedge and the employee's wealth. See id. at 251-252 (discussing preferred $3 million minimum notional amount and net worth requirements). Regulatory rules can also impact the employee's ability to hedge, although a 2004 Securities and Exchange Commission ("SEC") no-action letter has alleviated some of these concerns. In March, 2004, the SEC issued a no-action letter to Credit Suisse First Boston that provided confirmation of an insider's ability to enter into a collar on stock options under Section 16(c) of the Securities Exchange Act of 1934. See SEC Office of the Chief Counsel, Division of Corporate Finance, letter to Credit Suisse First Boston (March 18, 2004) available at http://www.sec.gov/divisions/corpfin/cf-noaction/csfb031804.htm.

[16] The parties' positions will be based on the stock that underlies the NQSOs. The FMV of the NQSOs derives from the FMV of the underlying stock, the stock's volatility, expected dividends, interest rates, the exercise price and the time to maturity of the options. See Brady and Gordon I, supra n. 6, at 243-244 (n. 2) (discussing "time premium" and "intrinsic value").

[17] See, e.g., Mary L. Harmon and Daniel P. Breen, "A Practical Guide to Equity Monetization," 18 PLI 601 (2003); Hedge Letter, supra n. 6 (describing use of a purchased put, a written call, a collar, a put spread, or a call spread).

[18] A properly structured hedge of the NQSO's economic risk would not appear to be a Section 1001 sale or other disposition under the common law, which would implicate Reg. 1.83-7(a). For a discussion of common law sale principles applicable to securities, see generally Robert A. Rudnick and Michelle L. Petock, "Forward Sale Contracts: The IRS's Recent Attempts to View Code Sec. 1259 as a Trap for the Wary," 3 J. Tax'n Fin. Prod. 19 (Summer 2002). The constructive sale rules of Section 1259 could apply if the taxpayer eliminated substantially all of the opportunity for gain and risk of loss with respect to appreciated NQSOs. Section 1259 can generally be avoided by building in "collar economics"; i.e., by retaining a portion of the upside and/or downside risk of economic exposure. For a discussion of Section 1259, see James H. Combs, "Will a Variation Lead to Consistency? Implications of Forward Contract Ruling For Hedging Appreciated Stock," 102 Tax Notes 1245 (March 8, 2004). Although the argument has been raised that the constructive sale rules may not apply to hedges of NQSOs (which give rise to "income" rather than the "gain" described in Section 1259), the "more conservative" position is that such hedges are subject to Section 1259. See Brady and Gordon I, supra n. 6, at 245.

ment from C less $2.7 million FMV), which offsets on a pre-tax economic basis the loss of the $300,000 compensation income that A did not receive because of the decline in the price of the B stock from $100 to $90 per share.

*(b)* If B stock increased in value to $150 per share at maturity, then A buys 30,000 shares of B stock worth $4.5 million for the $2.4 million exercise price and has compensation income of $2.1 million (i.e., $4.5 million FMV less $2.4 million exercise price). C exercises the "call" option inherent in the collar. A delivers to C 30,000 shares of B stock ($4.5 million FMV) in exchange for a payment of $3.45 million (30,000 shares x $115 per share collar exercise price). A has a loss of $1.05 million on the collar ($4.5 million FMV less $3.45 million payment from C), which offsets in part on a pre-tax economic basis A's increased compensation income from the rise in the price of B stock from $100 to $150 per share.

**Collars, options, and forward contracts on their own are not efficient hedging tools from an after-tax economic perspective when the hedge results in a loss.**

Collars, options, and forward contracts on their own are not efficient hedging tools on an after-tax economic basis when the hedge results in a loss. The losses on these contracts generally are capital in nature rather than ordinary;[19] capital losses do not (except to a limited extent) offset the ordinary compensation income from exercise of the hedged NQSOs.[20] If the underlying stock appreciates, there is increased ordinary income upon the exercise of the NQSO because income is measured based on the excess of the FMV of the stock over the amount paid for the stock. The increased ordinary income is offset on a pre-tax economic basis by the capital loss on the hedge, but these two items do not match in character.[21]

*Example 2.* Same facts as Example 1(b). A's ordinary income under Section 83(a) is $2.1 million (i.e., $4.5 million FMV less $2.4 million exercise price). A has a basis in the 30,000 B shares of $4.5 million and delivers these shares to C for a payment of $3.45 million ($30,000 shares x $115 per share collar exercise price). A's capital loss on the hedge is $1.05 million (i.e., A receives a payment of only $3.45 million for $4.5 million worth of B stock). A's capital loss generally does not reduce A's ordinary compensation income.

*Hedging Appreciated NQSOs with Swaps.* Notional principal contracts or "swaps" are also used for hedging appreciated financial positions. A short position in the underlying stock would be created by an agreement for the taxpayer to pay over all or a portion of the appreciation (and any dividends or other distributions) on a notional investment in stock during a specified term to the counterparty. The taxpayer would receive a periodic payment on a notional principal amount and a contingent payment at maturity equal to any depreciation in value on the notional investment in stock during the term of the contract.[22] The short position in the swap economically offsets the long position attributable to the NQSOs in the same manner as the short position in a collar, option, or variable delivery forward.

*Example 3.* Same facts as Example 1, except that A and C enter into an equity swap on B stock. Under the swap, A agrees to pay C fixed periodic payments equal to the dividends and other distributions on a notional investment of $3 million in B stock and a contingent payment at maturity equal to the appreciation (if any) above the first 15% of appreciation over the current $100 trading price (i.e., $115) on a notional investment of $3 million in B stock. C agrees to pay LIBOR plus a spread on a notional amount of $3 million and a contingent payment at maturity equal to the depreciation (if any) under the current $100 trading price on a notional investment of $3 million in of B stock.

[19] See Section 1234(a)(1) (character of loss on option transaction is of same character as underlying property); Section 1234A (capital gains or losses on certain transactions); Prop. Reg. 1.1234A-1(c) (capital loss on forward contracts). Gain or loss from the sale or exchange of NQSOs would not be covered by Section 1234(a)(1). Section 1234(a)(3)(B).

[20] Section 1211(b) permits taxpayers other than corporations to offset up to $3,000 of ordinary income with capital losses.

[21] Example 1(b) assumes that the NQSOs and the collar are not identified as an identified straddle under the rules discussed below and that a Section 1221 hedging election, described below in n. 24, is either unavailable or not made.

[22] The taxpayer's payment from the counterparty may be based, e.g., on the London interbank offered rate ("LIBOR") plus a spread times a notional principal amount of dollars.

Some practitioners have, depending on their view of the character of the periodic payments and final payment under an equity swap, advocated the use of a swap as a more tax-efficient hedging tool for NQSOs.[23] Unlike losses on collars, options and forwards, it has been asserted that both the periodic and nonperiodic contingent payments under a swap would give rise to deductions that are ordinary in nature.[24] This position had been based on the IRS' analysis in a 1997 technical advice memorandum involving a commodity swap. In TAM 9730007 (April 10, 1997), the IRS ruled that payments under a commodity swap did not give rise to capital gain or loss. The IRS reasoned that such payments did not result from a sale or exchange and were not Section 1234A "termination payments."[25]

Some practitioners have extended this analysis to payments, including the final contingent payment, under an equity swap, and have concluded that these payments also did not arise from a sale or exchange, and were not Section 1234A termination payments. Therefore, these practitioners argued that the payments give rise to ordinary deductions.[26] However, it should be noted that this view has not been universally accepted.[27] In terms of accounting for the timing of income and deductions, taxpayers usually took the position that the periodic payments under the swap were currently includible/deductible,

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but did not account for the final payment until the contingency was resolved at maturity of the contract (the so-called "wait-and-see" method).

In February 2004, the government proposed regulations that address both character and timing issues for contingent, nonperiodic swaps.[28] From a character standpoint, the proposed regulations confirm the belief that scheduled payments (including a scheduled contingent, non-periodic payment) give rise to ordi-

[23] See, e.g., Brady and Gordon I, supra n. 6, at 250-251.

[24] Restrictions on deductibility may still apply. See Brady and Gordon I, supra n. 6, at 251 (discussing potential application of limitations and phase-outs and the alternative minimum tax under Sections 67, 68 and 56). Another suggestion for hedging NQSOs in a manner that would confer an ordinary deduction has been the election of hedge treatment under Section 1221(b)(2), although not all commentators are convinced that this works. Compare Hedge Letter, supra n. 6; Brady and Gordon I, supra n. 6, at 249-250; Brady and Gordon II, supra n. 6, at 360; Schizer, supra n. 4, at 490-491; and Eastland and Daly, supra n. 6, at 31-28 to 31-29. Schizer also discusses the possible use of a contingent payment debt instrument linked to the underlying stock, a mark-to-market election for securities traders under Section 475(f), physically-settled derivatives and employer-provided hedges as still other theoretical alternatives for achieving an ordinary deduction. Schizer, supra n. 4, at 484-492.

[25] Section 1234A provides sale or exchange treatment for, among other transactions, the termination of a right or obligation with respect to property that is or would be a capital asset in the taxpayer's hands. The IRS reached its conclusion in TAM 9730007 even though the taxpayer argued that the swap could be equated with a series of cash-settled forward contracts, the closing out of which could give rise to capital gain or capital loss. The characterization of these payments as ordinary deductions rather than "losses" is the basis for the position that these expenditures are not currently caught by the straddle rules. See, e.g., John J. Ensminger, "Monetized Stock Positions, Index Instruments, and Other Frequently Ignored Straddles," 27 J. Corp. Tax'n 233, 249 (Autumn 2000). Proposed regulations under Section 263(g) would require capitalization of interest and carrying charges for straddles, which could affect a broad range of financial transactions, established on or after January 17, 2001, effective for such amounts that are paid, incurred or accrued after the proposed regulations are finalized. Prop. Reg. 1.263(g)-1—Prop. Reg. 1.263(g)-5. The proposed regulations could affect a broad range of financial transactions. See, e.g., Dimon and Farber, supra n. 4. Treasury has included finalization of the proposed regulations under Section 263(g) on its most recent guidance plan. See Office of Tax Policy and IRS 2005-2006 Priority Guidance Plan (August 8, 2005) ("Guidance Plan"), at 7.

[26] See Lewis R. Steinberg, "Using OTC Equity Derivatives for High-Net-Worth Individuals," in *The Use of Derivatives in Tax Planning*, Frank J. Fabozzi (ed.) (Frank J. Fabozzi, Inc. 1998) at 230 ("Others, including this author, believe that such payments are not termination payments, but are rather payments pursuant to the original terms of the swap and therefore give rise to ordinary income or loss."); Linda E. Carlisle and Geoffrey B. Lanning, "Character of Income, Deduction, Gain, or Loss From Notional Principal Contracts, Bullet Swaps, and Forwards Is Addressed in Proposed Regulations," 21 J. Tax'n Inv. 339 (Summer 2004).

[27] See David C. Garlock, "The Proposed Notional Principal Contract Regulations: What's Fixed? What's Still Broken?," 102 Tax Notes 1515, 1519 (March 22, 2004) (discussion of character issue); Paul D. Jacokes and Robert S. Chase, II, "The Proposed Contingent Notional Principal Contract Regulations (Warning: Don't Try This At Home)," 17 J. Tax'n F. Inst. 36, 44 (May/June 2004) ("It can be strongly argued that a scheduled nonperiodic payment that is determined and paid at the maturity of an equity or commodity swap can properly be viewed as a termination payment under a literal reading of Section 1234A").

[28] REG-166012-02, 69 Fed. Reg. 8886 (February 26, 2004). For a discussion of the proposed regulations, see David H. Shapiro and Michael J. Feder, "Observations on the Proposed Contingent Swap Regulations," US Tax Management Memorandum Vol. 45 No. 17 (August 23, 2004). Treasury's guidance plan for 2006 includes final regulations for contingent payment notional principal contracts among its projects. Guidance Plan supra n. 25, at 7.

nary deduction s rather than capital losses.[29] From a timing standpoint, the proposed regulations reject the wait-and-see method.[30] The proposed regulations require taxpayers to project the reasonably expected amount of the contingent payment under the swap and to account for these items currently using a "level payment" methodology.[31] Alternatively, the taxpayer can elect mark-to-market treatment.[32] The proposed method for contingent payment swaps has been viewed as making them potentially more costly and less tax-efficient.[33]

**From a character standpoint, the proposed regulations confirm the general belief that scheduled payments (including a scheduled contingent, non-periodic payment) give rise to ordinary deductions rather than capital losses.**

## TAX STRADDLES

**General Straddle Rules.** A hedge of NQSOs can create a Section 1092 "straddle," which can affect the tax consequences of the overall transaction.[34] A straddle involves "offsetting positions with respect to personal property."[35] A position is "an interest (including a futures or forward contract or option) in personal property."[36] Whether a position is offsetting is based on a substantial diminution of risk standard.[37] Section 1092(a)(1) provides the general rule for the deferral of straddle losses to the extent of the taxpayer's "unrecognized gain" in "1 or more positions which were offsetting positions."[38] For purposes of the general rule, "unrecognized gain" is the amount of gain that would be taken into account if a position were sold at FMV on the last business day of the taxable year.[39] A deferred straddle loss is carried over to the next taxable year.[40]

**Pre-AJCA Identified Straddle Rules.** Before amendment by the AJCA, a special "identified straddle" rule permitted taxpayers to identify the offsetting positions that made up a straddle.[41] This rule only applied if all of the positions were:

1. Clearly identified in the taxpayer's records by the earlier of the end of the day on which the

[29] See Prop. Reg. 1.162-30(a), 1.212-1(q)(1), 1.1234A-1(b). "Bullet swaps" (i.e., a contract that defers all payments to or near to maturity) and forward contracts give rise to capital gain or loss. See Prop. Reg. 1.1234A-1(c).

[30] Notice of Proposed Rulemaking, Fed. Reg. Vol. 69, No. 38, p. 8886 (February 26, 2004). The IRS had previously ruled on the "appropriate" timing rules for a particular contingent payment equity swap in Revenue Ruling 2002-30, 2002-1 CB 971, and identified certain similar swaps as a listed transaction. See Notice 2002-35, 2002-1 CB 992, modified by Notice 2006-16, 2006-9 IRB 538. These positions created significant uncertainty. See David P. Hariton, "Confusion About Swaps and Rev. Rul. 2002-30," 95 Tax Notes 1211 (May 20, 2002).

[31] See Prop. Reg. 1.446-3(g)(6). The taxpayer would reproject the reasonably expected amount annually and reapply the level payment method with adjustments.

[32] See Prop. Reg. 1.446-3(i).

[33] See Gina Biondo and Allison Rosier, "The Effect of the Proposed Swap Regulations on the Hedge Fund Industry: Goodbye to Total Return Swaps?" 103 Tax Notes 1171 (May 31, 2004). One commentator has speculated that the complicated method was proposed by Treasury to steer taxpayers to mark-to-market accounting. See Lee A. Sheppard, "Method in the Madness of the Contingent Swap Rules," 103 Tax Notes 281, 282 (April 19, 2004).

[34] Schizer, supra n. 4, at 479 (n. 153), notes a possible counterargument to the NQSO and the hedge constituting a straddle because options generate ordinary loss rather than capital loss, but ultimately finds the argument unconvincing. There has been less than complete agreement over the IRS' position that certain swaps can be an offsetting leg in a straddle. See, e.g., Ensminger, supra n. 25, at 249 (n. 42). The AJCA makes clear that Congress adopts the IRS' view. See H.R. Conf. Rep. No. 108-755 (October 7, 2004) at 757 (n. 867).

[35] Section 1092(c)(1).

[36] Section 1092(d)(2). "Personal property" for these purposes is any personal property of a type that is actively traded. Section 1092(d)(1). Special rules under Section 1092(d)(3) apply to straddles including stock, which rules were amended by the AJCA as described in n. 50 below. One exception from the straddle rules exists for a straddle in which all of the offsetting positions are composed of stock and "qualified covered call options" providing for the purchase of that stock, if not part of a larger straddle. Section 1092(c)(4)(A)(i) and (ii). A call option must meet numerous requirements to be a qualified covered call. Section 1092(c)(4)(B)-(E). NQSOs cannot be qualified covered calls because one requirement is that "gain or loss with respect to such option is not ordinary income or loss." Section 1092(c)(4)(B)(v). In Rev. Rul. 2002-66, 2002-2 CB 812, the IRS ruled that a collar transaction that included a qualified covered call resulted in a "larger straddle." Compare also Private Letter Ruling ("PLR") 199925044 (February 3, 1999) and TAM 200033004 (May 1, 2000).

[37] Section 1092(c)(2)(A). Rebuttable presumptions on whether positions are offsetting are set forth in Section 1092(c)(3)(A).

[38] The straddle rules were enacted to counter the abuses of the realization timing rules by taxpayers with economically offsetting positions in specified property. See JCT's General Explanation of the Economic Recovery Tax Act of 1981, (JCS-71-81), (December 29, 1981) at 283. ("The Act provides rules to prevent deferral of income and conversion of ordinary income and short-term capital gain into long-term capital gain on straddle transactions").

[39] Section 1092(a)(3)(A)(i). Another rule applies to positions with respect to which gain was realized, but not recognized, during the taxable year. Section 1092(a)(3)(A)(ii).

[40] Section 1092(a)(1)(B). The straddle rules can also affect the holding period for straddle positions. See Reg 1.1092(b)-2T(a).

[41] Pre-AJCA Section 1092(a)(2).

taxpayer acquired the straddle or as provided in regulations,
2. Acquired on the same day and either disposed of on the same day or not disposed of by the close of the taxable year, and
3. Not part of a "larger straddle."[42]

The identified straddle loss was deferred until the disposition of all positions in the identified straddle.[43] One problematic area involved "unbalanced straddles," i.e., straddles in which one position was larger than the other. Pre-AJCA Section 1092(c)(2)(B) provided that, for such unbalanced straddles, "the Secretary shall by regulations prescribe the method for determining the portion of such other positions which is to be taken into account for purposes of this section."[44] This statute created uncertainty because, absent guidance, taxpayers could not be assured that a straddle loss would be available upon disposition of the "identified straddle" if the IRS asserted that another position was part of the straddle.[45]

Regulations still had not been promulgated by 1999, almost two decades after the straddle rules became law, when the IRS issued a private letter ruling permitting the identification of positions in an unbalanced straddle.[46] In this ruling, the IRS acknowledged the lack of regulations under the then-existing version of Section 1092(c)(2)(B) and permitted the taxpayer to use "appropriately modified versions" of the basis identification procedures under Reg. 1.1012-1(c)((2) and (3) or the rules for mixed straddles under Temp. Reg. 1.1092(b)-3T(d)(4). This ruling was viewed by some tax practitioners as the IRS' position on identification of unbalanced straddle positions.[47]

**Post-AJCA Identified Straddle Rules.** The AJCA amended the identified straddle rules, including their application to unbalanced straddles.[48] Taxpayers may now identify positions in a straddle even if they are not acquired on the same day.[49] Identified straddle losses are no longer deferred until disposition of all positions in the identified straddle, but are accounted for by increasing the basis of the identified offsetting positions in the identified straddle by the amount of the losses.[50]

**Identified straddle losses are no longer deferred until disposition of all positions in the identified straddle, but are accounted for by increasing the basis of the identified offsetting positions in the identified straddle by the amount of the losses.**

Under the new law, the basis of each of the identified offsetting positions in the identified straddle is increased by an amount that bears the same ratio to the loss as the offsetting position's unrecognized gain bears to the total unrecognized gain of all such

[42] Pre-AJCA Section 1092(a)(2)(B).

[43] Pre-AJCA Section 1092(a)(2)(A)(ii).

[44] Pre-AJCA Section 1092(c)(2)(C) (renumbered Section 1092(C)(2)(B) by the AJCA) provides that any position that is not part of an identified straddle is not treated as offsetting to any position that is part of an identified straddle.

[45] Taxpayers had urged the issuance of guidance. See, e.g., Letter from Thomas D. Gennaro of the Wall Street Tax Association, Inc., to the Department of Treasury, 2000 TNT 34-25, Tax Notes Today (February 18, 2000).

[46] See PLR 199925044 (February 3, 1999).

[47] See, e.g., Mark J. Fichtenbaum, "Structuring Collars and Making Proper Identifications After Ltr. Rul. 199925044," 17 J. Tax'n Inv. 188 (Spring 2000).

[48] The AJCA deleted pre-AJCA Section 1092(c)(2)(B), so the unbalanced straddle rules no longer await the promulgation of regulations. The legislative history references PLR 199925044. See H. Rept. No. 108-548 (June 16, 2004), at 362-363; H.R. Conf. Rep. No. 108-755 (October 7, 2004), at 755-756. After the enactment of the identified straddle rules by the AJCA, the question was raised whether such rules would be effective prior to Treasury's promulgation of regulations implementing the statute. See Crystal Tandon, "Practitioners Discuss New Rules on Identified Straddles," 107 Tax Notes 947 (May 23, 2005). Section 403(ii) of the "Gulf Opportunity Zone Act of 2005," P.L. No. 109-135 (December 21, 2005) included a technical correction to the identified straddle rules to specify that the rules could be in the form of regulations or other guidance. The "Technical Explanation of the Revenue Provisions of H.R. 4440, The Gulf Opportunity Zone Act of 2005, PL 109-135 (December 21, 2005), § 403(ii), states that taxpayers can identify a straddle before Treasury promulgates regulations.

[49] Section 1092(a)(2)(B).

[50] Section 1092(a)(2)(A)(ii). In addition, Congress amended the exception for stock (and exceptions thereto) from the straddle rules. Section 1092(d)(3). In a change described in the legislative history as a "clarification," Congress provided that physical settlement of a straddle position that would give rise to a loss occurs in two steps: termination of the position at its FMV followed by a sale of the delivered property at its FMV. Section 1092(d)(8). The amended identified straddle rules exclude straddles that are part of a larger straddle and/or that are comprised of depreciated positions, except as provided in regulations. Section 1092(a)(2)(B)(ii) and (iii). The Secretary was also directed to issue regulations that address how a taxpayer that fails to properly identify a straddle is to apply the straddle rules and that address the tax consequences of dispositions of less than its entire position that is part of an identified straddle. Section 1092(a)(2). The new rules are effective for straddles entered into on or after October 22, 2004. See generally H. Rept. No. 108-548 (June 16, 2004), at 361-365; H.R. Conf. Rep. No. 108-755 (October 7, 2004), at 754-758.

offsetting positions.[51] Unrecognized gain, for purposes of the identified straddle rules, is specifically defined as the excess of the FMV of a position on the date the straddle loss is determined over its FMV as of the date the straddle is identified.[52] An identified straddle loss is "not otherwise taken into account for purposes of this title."[53]

**The Section 1012 regulations state that a property's basis is determined by reference to its "cost," which in turn is determined by reference to the "amount paid."**

## HEDGING NQSOS AFTER THE AJCA

An unanswered question after the AJCA is whether the legislation has opened up new opportunities for achieving better after-tax results for hedging NQSOs.[54] One possibility is that the increase in the "basis" (if the "amount paid" is treated as such basis) of an NQSO by the amount of the identified straddle losses reduces the ordinary income recognized upon the exercise, or arm's length sale or other disposition, of the option.[55]

*Example 4.* Same facts as Example 2, but A properly identifies the 30,000 NQSOs and the collar as an identified straddle and the straddle is not part of a larger straddle. A settles the collar prior to exercise of the NQSOs. A's $1.05 million loss on the collar is added to the basis/amount paid of the NQSOs, so A recognizes $1.05 million of compensation income (i.e., $4.5 million FMV of B stock less $2.4 million exercise price less $1.05 million identified straddle loss). If the identified straddle loss rules and Section 83 apply in this manner, then A has less compensation income and does not have a separate capital loss on the hedge.

**"Basis" of Property.** Section 1012 defines "basis" as the "cost" of property (subject to some exceptions).[56] The current regulations under Section 1012 in turn interpret "cost" as "the amount paid for such property in cash or other property."[57] Section 83 and the regulations thereunder contain numerous references to "amount paid" and "basis," setting up the possibility that an identified straddle loss could increase the basis of a NQSO in a manner that reduces ordinary income upon exercise as illustrated above in Example 4.

**Section 83—"Amount Paid" and "Basis."** Section 83(a) provides that upon exercise of the NQSOs the employee recognizes compensation income in an amount equal to the excess of the FMV of the acquired shares over the "amount paid" for the shares.[58] The regulations under Section 83 define "amount paid" specifically for purposes of Section 83.[59] The applicable

[51] Section 1092(a)(2)(A)(ii). This rule does not spread a straddle loss as a basis adjustment to other positions that are not identified as part of the straddle. An earlier unbalanced straddle proposal would have capitalized the loss into the offsetting positions of the larger leg. See JCT, Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal, (JCS-2-00), March 6, 2000 ("JCT Description"), at 345-346; Schizer, supra n. 4, at 480 (n. 160).

[52] Section 1092(a)(3)(B).

[53] Section 1092(a)(2)(A)(iii). Commentators have noted that one possible construction of this provision would result in the inability to recover an identified straddle loss if the identified offsetting positions did not have any "unrecognized gain." See "Coalition Seeks Changes to Recent Amendments to Straddle Rules," 2005 TNT 154-19, Tax Notes Today (August 11, 2005); "Aegon Requests Clarification of Straddle Rules," 2005 TNT 200-21, Tax Notes Today (October 18, 2005); "ACLI Suggests Technical Corrections to Straddle Provisions," 2005 TNT 201-24, Tax Notes Today (October 19, 2005).

[54] Separate from the technical analysis of whether straddle losses are capitalized into a NQSO's "basis" are the policy considerations of taxpayers potentially avoiding the capital loss restrictions of Section 1211 by entering into a hedge of a NQSO that generates a loss.

[55] See Schizer, supra n. 4, at 480 (n. 160); Dimon and Farber, supra n. 4, at 1267-1268 (raising the possibility of a result similar to that of the identified straddle basis rule occurring on account of the application of the Section 263(g) proposed regulations to "compensatory property straddles"). The tax law drafters have contemplated that the basis of property giving rise to ordinary income could be increased by a loss from an identified straddle. See JCT Description, supra n. 51, at 341-342 (discussing a proposed unbalanced straddle amendment's allocation of a straddle loss to two or more offsetting positions that "generate the most gain (or income)...").

[56] The basis of property for tax purposes has been relevant since at least the adoption of the income tax. Early versions of the Code defined the basis of property acquired after February 28, 1913 as its "cost." See Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estate, and Gifts*, ¶41.2 (citing the Revenue Act of 1918, ch. 14, § 202(a), 40 Stat. 1057, 1060, as the first appearance in the tax code). See also James E. Maule, 560-2nd Tax Management Portfolio ("T.M."), *Income Tax Basis: Overview and Conceptual Aspects*, at A-13 et seq. For an early article that explored in depth the issue of "basis" and the "cost" of property and that discusses the basis of property acquired pursuant to the exercise of an option, see Maurice C. Greenbaum, "The Basis of Property Shall Be The Cost Of Such Property: How Is 'Cost' Defined?" 3 Tax L. Rev. 351 (1948).

[57] Reg. 1.1012-1(a). See also Sections 1011 and 1016.

[58] See also Section 83(b)(1)(B) and Section 83(d)(2)(D).

[59] Reg. 1.83-3(g). The "amount paid" language of the Section 83 statute and regulations has its origin in regulations first issued in 1923. See TD 3435, II-1 CB 50 (1923) ("Where property is sold ... by an employer to an employee, for an amount substantially less than its fair market value, ... such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value."). For the history of the

definition of "amount paid" is (1) "the value of any money or property paid for the transfer of property to which Section 83 applies..." (the general rule) or (2) "any amount paid for the grant of the option plus any amount paid as the exercise price of the option" (for property acquired pursuant to an option).[60] The term "basis" is also used throughout the regulations under Section 83. The basis of property acquired pursuant to a NQSO includes the "amount paid" for the optioned property and the excess of the FMV of the optioned property over the amount paid.[61]

**Is the "Amount Paid" Equivalent to "Basis"?** Under a literal reading of the Section 83 regulations, an identified straddle loss is not part of the "amount paid" for a NQSO. A service provider does not "pay" a straddle loss either for the grant of an option or as part of the exercise price of the option.[62] Thus, an identified straddle loss would only reduce compensation income if the amount paid otherwise is treated as basis that is increased by the amount of the identified straddle loss.

The "amount paid" for a NQSO can fairly easily be thought of as basis under general tax principles for at least several reasons. First, the amount paid is used, like basis, to calculate the service provider's income upon exercise of a NQSO. Second, the Section 1012 regulations state that a property's basis is determined by reference to its "cost," which in turn is determined by reference to the "amount paid."[63] This suggests that "amount paid" is equivalent to basis, subject to adjustments. Third, Reg. 1.61-15(a) also appears to directly support the proposition that amount paid is equivalent to basis. That regulation states: "If an amount of money or property is paid for an option to which this paragraph applies, then the amount paid shall be part of the basis of such option." Finally, the "amount paid" for a NQSO under Section 83 has been referred to as basis in the NQSO by the IRS, commentators and in some case law involving the application of Section 83.[64] The foregoing demonstrates that amount paid and basis are intertwined concepts. However, none of these examples directly address whether amount paid and basis are interchangeable for purposes of the calcula-

**Based on the narrow definition of "amount paid" and other provisions of the Section 83 regulations, it appears that "amount paid" and "basis" are not interchangeable terms for purposes of Section 83.**

taxation of the authorities on stock acquired by executives pursuant to options, see William I. Sabin, "The Non-Restricted Employee Stock Option—An Executive's Delight," 11 Tax L. Rev. 179 (1956) (discussing TD 3435, II-1 CB 50 (1923); TD 4879, 1939-1 CB 159; TD 5507, 1946-1 CB 18; and I.T. 3795, 1946-1 CB 15). See also John H. Alexander, "Employee Stock Options and the 1950 Revenue Act," 6 Tax L. Rev. 165 (1951); Martin Atlas, "Toward A Concept of Compensation," 2 Tax L. Rev. 85 (1946); Victor E. Ferrall, "Employee Stock Options and the Smith Case," 4 New York University Annual Institute on Federal Taxation 449 (1946).

[60] Reg. 1.83-3(g). Reg. 1.421-6, the predecessor to Section 83, also calculated compensation by reference to the "amount paid." Reg. 1.61-15(a) states that, except as provided in Reg. 1.61-2(d)(6)(i) for post June 30, 1969 restricted property transfers, Reg. 1.421-6 applies to options (other than options subject to Section 421 or an investment option) received as compensation. Reg. 1.61-2(d)(1)-(5) provide rules for compensation paid other than in cash. Reg. 1.61-2(d)(6) limits the application of these rules for compensation paid with property (as defined in Reg. 1.83-3(e)) after June 30, 1969. See also Reg. § 1.83-8(b) (effective date and transitional rules for the application of Section 83). The legislative history to the enactment of Section 83 utilizes the phrase "amount, if any, paid" without discussion of how it relates to the basis provisions of Section 1012. See H. Rept. No. 91-413, 1969-3 CB 200, 255; S. Rept. No. 91-552, 1969-3 CB 423, 501 (reference to "amount paid"). Basis regulations promulgated in the 1950s and compensatory property regulations promulgated in the 1960s each use the "amount paid" language without explanation of the origins of the phrase. See TD 6265, 1957-2 CB 463, 470 and TD 6527, 1961-1 CB 153.

[61] Reg. 1.83-4(b)(1). See also Reg. 1.83-4(b)(2) ("If property to which §1.83-1 applies is transferred at arm's length, the basis of the property in the hands of the transferee shall be determined under section 1012 and the regulations thereunder").

[62] Reg. 1.83-3(g).

[63] Reg. 1.1012-1(a).

[64] See IRS Coordinated Issue Paper, "Transfer or Sale of Compensatory Options or Restricted Stock to Related Persons" (October 15, 2004), at 20; John L. Utz, 383-3rd T.M., *Nonstatutory Stock Options*, at A-16 (arm's length disposition of a NQSO only generates compensation income to the extent of the amount realized less the employee's "basis" and noting that "amount paid" has a "special meaning in the context of the exercise of an option..."); Bittker and Lokken, supra n. 56, at ¶60.5.4.1 (subsection of treatise entitled "Basis of options and underlying property" cites to Reg. 1.83-4(b) for the proposition that "basis" of a NQSO is the amount paid) and at ¶41.2.3 (stating that "cost or other basis of the [non-compensatory] option is added to the amount paid on exercising it in computing the taxpayer's cost basis for the underlying property," but cross-referencing ¶60.5 for "special rules" applicable to compensatory options); Albert J. Henry, et al., TCM 1997-29 (discussion of expert witness opinion that "zero basis" of an option was an indication that the option was granted as compensation); Weigl, 84 TC 1192, 1219 (1985) ("To the extent those sales were made in arm's-length transactions, Federman Inc. is taxable in the year of those sales based on the amount realized from the sales over its adjusted basis in the warrants"). A stock option that is taxable at grant does have a basis that is determined by reference to the "amount paid" for the option. See Utz, supra at A-5 (n. 40); Utz, supra at A-14 (describing the basis of an option taxed at grant).

tion of compensation income under Section 83 and, if so, whether an identified straddle loss increases the amount paid.

Other provisions of the Section 83 regulations make clear that there are distinctions between basis and amount paid. For example, a taxpayer's "basis" in substantially nonvested property for which a Section 83(b) election is made equals the amount paid (if any) for the property plus the amount of income included under Section 83(b).[65] If such property is in effect forfeited while substantially nonvested, it is treated as a loss from the sale or exchange of the property. The amount of this loss equals the excess, if any, of the "amount paid, (if any)" for the property over the amount realized (if any) upon the forfeiture.[66] Under this rule, the service provider can deduct the "amount paid" for the property, but cannot deduct its "basis" in the property because the previous income inclusion is nondeductible.

**A service provider faced with the decision to properly identify a hedge and NQSOs as an identified straddle must consider the after-tax consequences of the identification.**

Another example is Reg. 1.83-4(b)(1), which establishes the rules for determining the basis of substantially nonvested property for which a Section 83(b) election is not made. Basis, for these purposes—

> shall reflect any amount paid for such property and any amount includible in the gross income of the person who performed the services (including any amount so includible as a result of a disposition by the person who acquires such property).

Here, the "amount paid" for the property is treated as a component of its basis, but is not treated as equivalent to the basis.

Based on the narrow definition of "amount paid" and other provisions of the Section 83 regulations, it appears that "amount paid" and "basis" are not interchangeable terms for purposes of Section 83.[67] As a result, it appears that an identified straddle loss would not increase the "amount paid" for a NQSO and would not thereby reduce the ordinary income from exercise, sale or other arm's length disposition of the NQSO.[68]

## WHAT HAPPENS TO A STRADDLE LOSS FROM HEDGE OF NQSOS?

A service provider faced with the decision to properly identify a hedge and NQSOs as an identified straddle must consider the after-tax consequences of the identification. This requires an understanding of how the general straddle loss deferral rules apply to a loss on a hedge versus how the identified straddle loss rules apply.

**The Hedge and NQSOs Are Not Identified as an Identified Straddle.** If a service provider hedges appreciated NQSOs and does not identify the positions as a straddle under Section 1092(a)(2), then any loss on the hedge will be deferred to the extent of the unrecognized gain (which includes all gain on the NQSOs and not just gain since entry into the straddle) in the NQSOs held at the close of the taxable year. Upon exercise of the NQSOs, the service provider would recognize all of the "unrecognized gain" in the NQSOs as compensation income. The service provider could then deduct the straddle loss without deferral under Section 1092(a)(1) (assuming that the service provider had not entered into any additional straddles).

*Example 5.* Same facts as Example 2. A's "unrecognized gain" of $2.1 million (i.e., $4.5 million FMV less $2.4 million exercise price) is all recognized upon exercise of the NQSOs. The capital loss of $1.05 mil-

[65] Reg. 1.83-2(a). See also Reg. 1.83-4(b) (basis of acquired Section 83 property).

[66] See also Reg. 1.83-1(b)(2) (the amount of loss from the forfeiture of substantially nonvested property for which a Section 83(b) election has not been made is based on the excess of the amount paid (if any) for the property over the amount received (if any) upon the forfeiture).

[67] Other Code provisions that could potentially offer insight into the "basis" of NQSOs include, without limitation, Sections 165 (losses), 1014 (basis of property acquired from a decedent), 1015 (basis of gifted property) and 1041 (transfers of property between spouses or incident to divorce). For various reasons, "basis" of the NQSOs generally does not appear to be relevant to the application of these rules. See Wright, TCM 1983-707, aff'd, 756 F.2d 1039 (CA-4 1985) (distinguishing between Section 165 losses and losses under Section 83); Utz, supra n. 64, at A-18(1) (discussing the potential character of the employee's loss when an employer cancels NQSOs); Utz, supra n. 64, at A-16 to A-17 and A-30 to A-31 (discussing Sections 1014, 1015 and 1041).

[68] If the taxpayer did increase amount paid by capitalized straddle losses, this would raise other issues. See Dimon and Farber, supra n. 4, at 1267 (noting the issues raised under the proposed Section 263(g) regulations for the employer's deduction and payroll taxes under Section 83(h) and on the FICA/FUTA wage base under Sections 3101 and 3111).

lion on the collar is not deferred under the general straddle rules.

**The Hedge and the NQSOs are Identified as an Identified Straddle.** If the service provider identifies the hedge and the NQSOs as an identified straddle, then any hedge loss increases the "basis" of the identified offsetting position (the NQSOs) based on the service provider's "unrecognized gain" (which here only includes gain since the date of entry into the straddle). As set forth above, it does not appear that this identified straddle loss adjusts the service provider's "amount paid" for the NQSO or the "amount paid" at exercise of the NQSO. Therefore, this "basis" would not be recovered upon exercise as reduced compensation income. However, there are other possibilities for the recovery of the identified straddle loss, the least likely of these being that the taxpayer could never deduct that loss, although such a result has been proposed under other fact patterns.[69]

*Deduction Upon Exercise of the NQSOs.* A deduction of the identified straddle loss upon exercise of the NQSOs would be consistent with the general straddle loss deferral rule of Section 1092(a)(1). Under the general rule, the straddle loss is deferred only so long as there is unrecognized gain in an offsetting position. However, a deduction of the identified straddle loss at exercise of the NQSOs appears inconsistent with the plain language of the Section 1092(a)(2) identified straddle rule, which requires that such loss increase the basis of the identified offsetting position. In this case, the service provider arguably has not yet disposed of the offsetting identified straddle position, so it appears that the deduction is not available.[70] Nevertheless, such a deduction would be consistent with the spirit of Section 1092(a)(2) because exercise of the NQSOs eliminates all of the service provider's "unrecognized gain."

*Deduction Upon Taxable Disposition of the Stock.* Another possibility is that the identified straddle loss would be includible in the basis of the stock purchased pursuant to the exercise of the NQSOs. Reg. 1.83-4(b)(1) and Section 1016(a)(1) appear to provide some additional support for this treatment. Reg. 1.83-4(b)(1) provides the basis rules for property acquired pursuant to an option, and explicitly cross-references Section 1016. Section 1016(a)(1) provides that, with certain exceptions, a taxpayer must adjust a property's basis for "expenditures, receipts, losses, or other items, properly chargeable to capital account ...." An identified straddle loss appears to fall within the "losses" described in Section 1016(a)(1). A service provider who exercises the NQSOs before settling the hedge may more clearly be able to obtain this result.[71] At the time the hedge is settled, the service provider would then hold only stock as the identified offsetting position.[72] The service provider would then increase the stock basis by the identified straddle loss.[73]

**A deduction of the identified straddle loss at exercise of the NQSOs appears inconsistent with the plain language of the Section 1092(a)(2) identified straddle rule, which requires that such loss increase the basis of the identified offsetting position.**

*Example 6.* Same facts as Example 5, but A properly identifies the 30,000 NQSOs and the collar as an identified straddle and the identified straddle is not part of a larger straddle. A's unrecognized gain since entry into the straddle of $1.5 million (i.e., $4.5 million FMV at maturity less $3 million FMV of B stock on the date of entry into the straddle) is

[69] See discussion in n. 53 regarding a possible reading of Section 1092(a)(2)(A)(iii) that would permanently deny recovery of an identified offsetting straddle loss. It is also possible to interpret this provision as providing that only an identified straddle loss that has actually been capitalized into the basis of an identified offsetting position is not otherwise taken into account. This interpretation of the provision does not answer the question of what happens to an identified straddle loss that cannot be capitalized under the statutory formula. These issues are also discussed in a 2005 NYSBA letter to various Congresspersons. See "NYSBA TAX Section Comments on JOBS Act Straddle Amendments," DTR (November 15, 2005).

[70] An early case holding that exercise of an option is not treated as a taxable disposition of the option is Helvering v. San Joaquin Fruit & Investment Co., 297 US 496 (1936).

[71] The post-AJCA straddle rules contemplate regulations to address straddle losses when only a portion of an identified straddle is disposed of. See Section 1092(a)(2)(C).

[72] Presumably, stock acquired pursuant to a derivative financial contract identified as part of a straddle would also qualify as an identified straddle position without the need for an additional identification of the stock as part of an identified straddle.

[73] For non-compensatory options, the application of the identified straddle capitalization rule is more straightforward. With a non-compensatory option, the taxpayer would not recognize gain or loss upon option exercise, so there would still be unrecognized gain in the identified offsetting position (the stock) at the time the straddle loss was realized. See Rev. Rul. 78-182, 1978-1 CB 265 (Ruling A.4). This ruling cites Rev. Rul. 58-234, 1958-1 CB 279, as authority for the basis of property acquired pursuant to an option.

all recognized upon exercise of the NQSOs (i.e., there is no longer any "unrecognized gain"). The identified straddle loss of $1.05 million increases the basis of the identified offsetting positions (presumably the stock).

*Guidance From Treasury/IRS Appears Necessary.* Treasury and/or the IRS should provide taxpayers guidance confirming that, if an identified straddle loss does not increase the service provider's "amount paid" and reduce compensation income upon exercise, then the service provider can deduct (subject to other limitations in the Code) the identified straddle loss either upon exercise of the NQSOs or upon a taxable sale or other disposition of the stock acquired pursuant to the NQSO. Absent such guidance, taxpayers are faced with substantial uncertainty as to whether to make the identified straddle election when hedging NQSOs.

## CONCLUSION

The AJCA has had broad-reaching effects (and caused much confusion) in a number of readily-identifiable areas. Congress's amendments to the straddle rules of Section 1092 offer a measure of simplification in a complex area. However, like squeezing a balloon, addressing known issues in one area can generate new issues in other areas. It appears that the AJCA's amendments to the identified straddle rules have such an effect, and present a situation that calls for administrative guidance to resolve. ■