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Reid Thompson

David A. Weisbach

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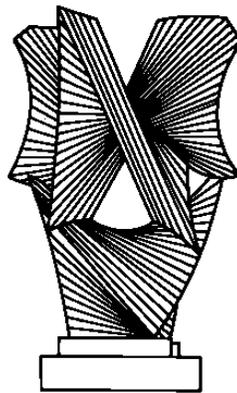
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Attributes of Ownership

Reid Thompson and David Weisbach

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Attributes of ownership

Reid Thompson and David Weisbach
The University of Chicago Law School*

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Abstract

We examine the tax rules for ownership of fungible securities in light of three recent cases addressing this issue, *Samueli*, *Calloway*, and *Anschutz*. We argue that ownership has no economic basis under an income tax because under a pure income tax ownership would not be needed to measure income. Rather than acting as a bedrock principle based in economics, ownership in a realization-based income tax acts as a default rule for assigning tax characteristics to positions. For example, ownership determine characteristics such as holding periods, eligibility for special tax benefits such as the dividends received deduction, counting toward control or as qualifying consideration for various purposes, and so forth. Each of these characteristics, which we label tax attributes, is motivated by different policy considerations. Given the wide variety of policies behind the various tax attributes, no single concept of ownership can be expected to be appropriate in all cases. Therefore, tax rules for each characteristic start with the default rule of ownership but modify the assignment of the attribute based on the relevant policy considerations. Viewing ownership, as a mere default for assigning tax attributes, we propose a simple and clear rule for ownership of fungible securities which produces results similar to those of current law and yet which avoid the problems created by the recent court decisions on ownership of fungible securities.

* We thank Alex Raskolnikov and participants at a workshop at the Washington University, St. Louis, for comments.

Compare two investments. In the first, you instruct your broker to buy a share of stock in a public company, say, IBM. In the second, you enter into a derivative contract with a bank that promises to pay you a return identical to the stock; you pay an amount upfront equal to the current price, the bank pays you an amount equal to any dividends on the stock, and when you want to sell it, the bank will pay you its then current value less a brokerage fee. The tax law treats you as owning stock in the first case and not owning the stock in the second case. Instead, in the second case, you have a mere contract with the bank.

Now suppose that, in the case where you buy actual stock, you borrow an additional share from your broker and sell it short, in a transaction known as a short against the box. You are insulated from risk and opportunity, have no net dividend receipts, and will be able to receive most of the cash from the short sale (because you can use your long stock position as collateral). Two leading tax scholars, Ed Kleinbard and Alex Raskolnikov, have written (separately) that you continue to own your original shares for tax purposes.¹ To our knowledge, they correctly describe the law.

What does it mean to say you own stock in these cases? Ownership apparently has nothing to do with whether you are exposed to an economic position. The first example shows that you can be completely exposed yet not be treated as owning stock. The second example shows that you can have no exposure and yet be treated as owning the stock.

If you thought ownership meant title and possession, you would also be wrong. You have neither when you buy stock. As we shall see, in modern securities markets, title to most stocks is held by an entity you likely never heard of – Cede & Co. You merely have a claim that is very much like a contract right against your broker. It is not clear what possession means for something that is virtual but whatever it may mean, you don't have that either. Cede holds the stock certificates.² Ownership for tax purposes means something not related to the economics and not based on actual possession or title.

These puzzles have long intrigued tax scholars, who love conundrums, and created opportunities for tax planners, who salivate at the prospect of economically identical positions that are treated differently. They have also

¹ Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 *Taxes* 783 (1993); Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 *B.U. L. Rev.* 431 (2005).

² Given that Cede has both title and possession of most securities, it is a favorite target for conspiracy theories about Eastern financial syndicates. Internet searches on Cede are entertaining.

attracted the recent attention of the Internal Revenue Service, and the Tax Court, which, in three recent cases has begun a re-examination of tax ownership of fungible securities.³ In each case, taxpayers tried to manipulate ownership to gain a tax advantage, either by avoiding or retaining ownership while having the economics or retaining or avoiding. In each case, the Service challenged those claims, and the Tax Court held that the attempts to manipulate ownership were unsuccessful. The cases potentially claw back some of the results described above by trying to base tax ownership on the economics. Nevertheless, the core results we described above appear to remain valid which means that the cases increase the conundrums rather than reduce them.

Motivated by these cases, we reexamine the concept of tax ownership of fungible securities and other financial products. We start by trying to carefully describe the role that ownership plays in our tax system. As noted, it does not appear to be based on economics. This is for good reason. In a pure Haig Simons tax system, ownership would be irrelevant as all that would matter is changes in value. There is, therefore, nothing fundamental about ownership in an income tax. There is no bedrock. As a result, attempts to rely on economic principles to determine ownership are doomed.

Ownership, we argue, functions simply as a default assignment of what we call attributes. Attributes are the rules that govern deviations from a pure Haig-Simons base. The term is commonly used to refer to character and source but we mean it more generally. An alternative phrase could be “tax characteristics”. Realization and nonrealization are attributes or characteristics. So are the holding period, the dividends received deduction or net capital gain on dividends, withholding on cross-border dividends, tax exemption for interest, the foreign tax credit, the original issue discount rules, treaty eligibility, counting toward control tests of various sorts, and numerous other components of the tax computation for a position. Attributes are needed when we deviate from a pure income tax. The role ownership plays is as an initial, default assignment of attributes; owners of a security are eligible for the attributes associated with the security.

Ownership, however, is merely a default rule for assigning attributes. It acts as a starting place and is not what fundamentally matters. Instead, the rules for each attribute start with ownership but then reassign the attribute based on the relevant policy considerations. For example, when we say someones owns stock,

³ *Samueli v. Commissioner*, 132 T.C. 37 (2009), aff’d, 658 F.3d 992 (9th Cir. 2011); *Calloway v. Commissioner*, 135 T.C. 26 (2010); *Anschutz Co. v. Commissioner*, 135 T.C. 78 (2010), aff’d, 644 F.3d 313 (10th Cir. 2011).

we mean that only the ownership position is initially assigned the attributes associated with stock. We initially assign the dividends received deduction to the owner. Sometimes, however, we take away that assignment based on the policy considerations. If you hedge your risk from owning the stock, you may lose the dividends received deduction. And sometimes we assign contractual holders some attributes of ownership, such as dividend withholding because, for policy reasons related to those attributes, he should have those attributes.

This should not be surprising because the policies behind different attributes differ. A concept of ownership that satisfies the purposes behind one attribute will not necessarily work for other attributes. For example, the purpose behind the exemption for municipal bond interest is different from the purpose for the realization requirement which is different from the purposes behind the dividends received deduction, the foreign tax credit, the OID rules, or cross-border withholding. There is no reason to expect that a single concept of ownership will suffice for all of these different purposes. It would be surprising if that were the case.

Given these observations, we suggest a reformulation of the rule for ownership of fungible securities. Our goal is a rule which minimizes the costs of assigning attributes. We do this by specifying an ownership rule that gets it right for the overwhelming majority of cases and that is simple to understand and apply. With a clear ownership rule, attribute assignment rules that deviate from the default will then be able to adjust attributes to reflect the relevant policies.

An initial intuition is that title is the correct default rule. Title may work for many assets, but it does not work for street name securities. As we mentioned, investors who “own” a street name security do not in fact have title. Title to most securities is held by a centralized depository, such as the Depository Trust Corporation through its special purpose entity, known as Cede & Co. Possession does not work either. If the securities are certificated, Cede holds the certificates, so Cede has possession.

Investors instead have a unique contractual claim called a “securities entitlement,” governed under Article 8 of the UCC, which we will describe in more detail in Part 3. We propose that for street name securities, the holder of the securities entitlement be treated as the owner for tax purposes. For securities not held in street name, the titleholder is the owner. For contractual relationships, such as most derivative contracts, the contracting parties are the owners of their

respective positions. We discuss possible exceptions to these rules such as for repo transactions.

We by no means write on a blank slate. Ownership has perplexed scholars for a long time. There are two relatively recent articles on ownership of fungible securities that we highlight up front because they have been particularly useful in our thinking and because our arguments either use or shed light on the considerations discussed in those articles.

The first is Ed Kleinbard's article, *Risky and Riskless Positions in Securities*.⁴ Kleinbard's article is largely positive, attempting to explain the law as of the time he was writing (although he alludes to our argument in a paragraph in his introduction).⁵ He argues that ownership of fungible securities depends only on formal title and the ability to dispose of the security to an outright market purchaser. The claim is that as long as a taxpayer has title and the ability to dispose of the security, he is the owner, even if he has no other attributes of ownership, particularly even if he has hedged away all risk of loss and opportunity for gain. This approach contrasts with the rules for other types of property, where ownership depends in part on having economic exposure to the returns from the property. Moreover, Kleinbard argues that if the taxpayer does not have title and the ability to dispose, he is not the owner even if he is fully exposed to the risk.

While Kleinbard's paper is positive and our proposal is normative, our proposal would produce results very similar to those he describes and to a great extent for the reasons he describes. That is, while we believe that there is no fundamental concept of tax ownership (it is not clear whether Kleinbard does), a system similar to the one Kleinbard describes is likely a good default rule.⁶ Our key difference with Kleinbard is that we believe that his focus on ownership misses the most important part of the transactions he considers, which is how tax attributes are assigned not how ownership is determined.

The second is Alex Raskolnikov's article, *Contextual Analysis of Tax Ownership*.⁷ He provides a positive analysis of ownership under the tax law (generally, as opposed to just fungible securities). He argues that ownership determinations depend on the context, dividing the world between fungible and

⁴ Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 *Taxes* 783 (1993).

⁵ Kleinbard at p. 785.

⁶ As discussed in Part 3, our proposal depends on Article 8 of the UCC, which was amended in 1994, after Kleinbard wrote.

⁷ Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 *B.U. L. Rev.* 431 (2005).

nonfungible assets and between “when” questions and “whether” questions. With respect to fungible securities, Raskolnikov’s description of the law largely mirrors Kleinbard’s: ownership of fungible securities in Raskolnikov’s view is based on possession and the right to dispose, and of those two, the right to dispose is by far the more important.

We agree that ownership should depend on context but take a somewhat different approach by arguing for a formalistic definition combined with rules for claiming or receiving the relevant attributes. Like with Kleinbard, our difference with Raskolnikov is that we think, by focusing on ownership, he misses the most important parts of the transactions he considers. The law should focus more on attribute assignment provisions like sections 246(c) and 1259, and less on ownership.⁸

Before we begin the analysis, we need to clarify an awkward terminological point. Our paper is about the proper analysis of ownership for tax purposes. Because the term ownership is the variable being considered, using it colloquially can create confusion. If we say “consider someone who owns a share of stock” the meaning is unclear because we are trying to determine when someone owns the stock. Describing simple transactions, such as “owning” a share of stock, without using the term is awkward, however. If we say that a taxpayer owns a share of stock free and clear, we suspect that everyone will still understand what we mean. We try to only use the term when its meaning is unambiguous. To the extent that there are ambiguities, we mean ownership in the sense of our proposal.

Part 1 analyzes the role that ownership plays in our current tax system, establishing the core of our argument that ownership is a mere default rule for assigning of attributes. Part 2 considers the three recent Tax Court decisions. Part 3 outlines our proposal for determining the ownership of fungible securities. Part 4 concludes.

1. Ownership in the tax law

We develop our thesis by working through a series of examples to explore the role that ownership plays in our tax system, focusing on ownership of financial instruments. We start with the simplest possible transaction, an ordinary investment in a share of stock and compare that to a financial contract that gives

⁸ Raskolnikov provides an extensive list of articles on tax ownership. See notes 1-4 in Raskolnikov. We refer readers interested in the background literature there.

the taxpayer the identical economic return. We then turn to more complex transactions. The analysis establishes three points: first, that a Haig-Simons income tax would not need ownership; second, ownership acts as a default rule that assigns tax attributes on an initial basis; third, attributes are subsequently reassigned based on the relevant policy considerations for each attribute. Ownership and non-ownership are less different than they look at first, and the differences and similarities are matters of policy choice about the assignment of attributes not something inherent in the nature of ownership.

Ownership of a share of stock compared to a contractual right

Suppose that you instruct your broker to buy a share of stock for your account. The stock is unhedged, and you get all of the things that one might think come with ownership including the economic return on the stock, dividends, the vote, and recognition in the market that you are the owner.

Compare this to a contractual right to the economic returns on the same share of stock. There are any number of such contracts available in the market, but for simplicity suppose that a financial institution, in return for cash equal to the current value of the stock, promises to make dividend equivalent payments and, when the you decide to sell the stock, pay you its then current price. Other than exposure to the credit of the bank (which, say, is managed through a collateral account and which we will ignore in subsequent discussion by assuming it is well managed), your rights are identical to those of an ordinary stockholder.

We tend to think of the first position – buying actual shares – as involving ownership of the stock and the second – a contract giving the taxpayer/investor the economic return on stock – as not, even though the two positions have identical returns.⁹ The question is what is the difference? What does it mean to say for tax purposes that the first position involves ownership of stock and the second does not when the two are economically identical?

Start by noting that the two positions would be treated identically under a Haig-Simons or mark-to-market tax for the simple reason that they are economically identical. A Haig-Simons tax does not need to determine whether you own stock or merely have contractual rights that are identical to owning

⁹ As we will discuss in Part 3, if the stock is held in street name, the two positions are actually both just contractual rights. A nominee has both title to the stock and possession of the stock. The nominee enters into a contract with the person we think of as the owner. The contract provides for all of the economic returns to the stock as well as the vote. The tax law characterizes this contract as ownership of stock even though title and possession are elsewhere.

stock. All that matters is the values of the positions which, by assumption, are the same.

Current tax law, however, treats the two positions differently. To get a sense of the pattern, consider some examples.

- *The dividends received deduction and net capital gain.* One of the starkest differences between the two positions is that only an owner of stock can receive payments characterized as a dividend for tax purposes, so that the payment is eligible for the dividends received deduction or to be treated as net capital gain.¹⁰ The holder of the contractual right is treated as receiving contractual payments, not dividends.
- *Stock for subchapter C purposes.* Subchapter C provides numerous rules governing transactions involving stock, such as contributions of property to a corporation in exchange for stock, sales of stock to the issuing corporation, receipt of stock in certain reorganizations, sales of stock of controlled corporations to related parties, and so forth. For the most part, only actual stock and not contractual rights count as stock for these purposes.
- *Consolidated returns, subpart F, and subchapter S.* Various tax rules look to ownership to determine the status of a corporate entity. For example, the consolidated return rules require group members to hold 80 percent of vote and value of a corporation to be included in a consolidated return.¹¹ To be a controlled corporation, subpart F requires a 50 percent ownership in a foreign corporation by persons who own at least 10 percent of the stock.¹² Subchapter S limits ownership to 100 shareholders.¹³ All of these rules, as a first order matter, look to stock ownership, not contractual rights. Regardless of how many contractual rights someone buys from a bank, they will not be allowed to include the corporation in their consolidated return because of the investment.

¹⁰ Under section 301(a) and (c), dividends are distributions on stock. Stock is not defined but it involves a relationship with the issuing corporation not a third party financial institution. Therefore, only the stockholder and not the contractual party can receive a dividend. As we will see, however, all street name stock is contractual, so section 301 involves an implicit notion that particular types of contractual arrangements are stock and other types are not. Our proposal to treat only securities entitlement holders as owners resolves this problem. The dividends received deduction may be claimed under section 243 for dividends and not for mere contractual payments. Section 1(h)(11) grants net capital gain treatment for certain dividends .

¹¹ Section 1504(a)(1) and (2).

¹² Section 957.

¹³ Section 1361(b)(1)(A).

We can see from these examples that ownership is operating to determine how to treat particular transactions. We think of this as assigning tax attributes or characteristics, such as “eligibility for the dividends received deduction,” “good consideration for continuity of interest purposes,” or “counting toward the required percentage to be included in a consolidated return.” There are numerous attributes because measuring income under a realization-based system is complex, because we have a two-level, worldwide corporate tax, and because we try to implement a vast number of social policies in our tax system.

The tax law uses ownership as the basic tool, essentially a default rule, for assigning tax attributes because in the ordinary course, it works well. In most cases, all of the relevant attributes should move together, so ownership does all of the necessary work. We only need to decide who is the owner to decide who gets all of the attributes.

Because it is so commonly used, ownership can be mistaken for the fundamental property which determines the assignment of attributes rather than a default which is overridden based on policy considerations unique to each attribute. In fact, most attributes are assigned on a more complex basis, and as transactions and the tax law evolves, the particular rules for assignment of each attribute have evolved as well, most often moving beyond mere ownership. Consider the following examples.¹⁴

- *Section 318.* Section 318(a)(4) treats holders of options as holding the stock, and it seems likely (although it is not sure) that our contractual arrangement would fall under this rule. Where 318(a)(4) applies, the contractual right creates aspects of ownership. For example, under section 302, whether a redemption is treated as a dividend or a sale or exchange depends on the redeemed shareholder’s relative ownership of the corporation before and after the redemption. For purposes of determining ownership under section 302, some contractual rights (or more specifically

¹⁴ Rev. Rul. 82-150 is perhaps a counter-example to the thesis because it assigns actual tax ownership to a purported non-owner rather than just attributes. The taxpayer in that ruling paid \$70,000 to purchase a deep in the money option to buy stock of a foreign company for \$30,000 when the stock was worth \$100,000. By treating himself as owning only an option and not the stock, the taxpayer claimed to be able to avoid the foreign personal holding company rules. The foreign personal holding company rules (since repealed) included an option attribution rule (found in section 554(a)(3)) but the rule requiring inclusion of foreign personal holding company income only applied to actual shareholder. Option attribution, therefore, did not apply to assign the correct attributes (the requirement to include foreign person holding company income) to the taxpayer. The Service, therefore, resorted to a claim that the deep-in-the-money option created actual ownership.

options), are treated as actual ownership by virtue of section 318(a)(4). Note that section 318 applies only where specified and is not a general rule. Congress has made a policy choice to treat options as ownership for some purposes and not others.

- *Other option attribution rules.* Rules treating contractual rights as owning stock are not limited to section 318. Similar rules can be found in the consolidated return rules (section 1504), the subpart F rules (section 958), the controlled group rules (section 1563), and the personal holding company rules (section 544). Like with section 318, Congress has decided that mere contractual rights should be treated as ownership for particular purposes and not others.
- *Section 1260.* Section 1260 was enacted in response to transactions where taxpayers purposefully avoided ownership because they did not want the associated attributes. In particular, owners of hedge funds would typically receive short-term capital gains in the current year reflecting the rapid trading activity of hedge funds and their pass-through structure. Rather than owning an interest in a hedge fund, taxpayers would purchase a derivative contract on a hedge fund essentially identical to the stock derivative described above. The securities dealer issuing the derivative would buy an interest in the hedge fund but because dealer used mark-to-market accounting, the long ownership position in the hedge fund and the short derivative position with the investor simply offset, so the dealer was indifferent. As a result, taxpayers could convert short term gain included currently into long term gain included whenever the derivative was closed. Section 1260 attempts to limit the tax benefits of avoiding ownership in this fashion but it does not do so by treating taxpayers with mere derivative positions as owning the hedge fund. Instead, it assigns some of the attributes of ownership to such taxpayers, most importantly recharacterizing the gain as short term and imposing an interest charge for the deferral.¹⁵

¹⁵ Section 1260 in its current form applies to derivative positions in pass through entities and not positions in stock. The Treasury Department has authority to apply it to derivatives positions in stock such as position considered here. To date, no regulations have been issued.

Tax shelters associated with mark to market accounting by securities dealers often manipulate ownership. When enacted, many thought mark to market taxation for securities dealers would eliminate sheltering by these entities because their tax would be based purely on their economic income. To many people's surprise, mark to market accounting created tax shelter opportunities such as the one described in the text. One way to think about why this happened is that ownership does not matter for mark to market taxpayers while it does for everyone else. Anytime ownership is associated with tax attributes that are undesirable, a mark to market

- *Section 871(m)*. Section 871(m) was also enacted because taxpayers were avoiding ownership, in this case to avoid dividend withholding on cross-border payments.¹⁶ Rather than investing in stock, taxpayers would invest in a swap contract that gave them the same returns as investing in stock.¹⁷ Payments on the swap equivalent to dividends were not subject to withholding unlike actual dividends. Section 871(m) treats dividend-like payments on certain derivatives as subject to withholding, effectively assigning one particular attribute to these payments but not changing who owns the underlying stock.

We can see from these examples that the tax law sometimes treats the contractual right as ownership for particular purposes but not for others. Ownership is a default rule that we override when appropriate.

Own but hedge.

The pattern described above can be seen clearly in the case where a taxpayer owns the stock (in the sense of the simple stock purchase considered above) but hedges his risk. The classic example is a short against the box transaction, in which a taxpayer who owns stock outright borrows identical shares and sells them short in the market. The taxpayer has completely eliminated the economics of stock ownership because the short and long positions exactly offset. He has neither the opportunity for gain, the risk of loss, nor the right to dividends. The two positions completely collateralize one another so that the taxpayer is able to receive most of the cash from the short sale, thereby not only eliminating the economics of the original long position but also giving the taxpayer cash.

There are numerous other examples which use more sophisticated contractual arrangements, enabling investors to better tailor their returns. Taxpayers who own stock can be short the stock in a total return swap (and be long whatever is specified in the contract), a forward contract, or a deep in the money option. They can use costless collars to eliminate a specified portion of upside and downside. They can borrow non-recourse against the stock and pair

taxpayer can take ownership and use derivative contracts to give the same economic return to other taxpayers while avoiding ownership.

¹⁶ Technically the result arose because of the source rules for swaps but we can think of the source rules for swaps as differing from the source rules for dividends because of the underlying assumption that dividend equivalent payments on swaps are not actual dividends.

¹⁷ See *Dividend Tax Abuse: How Offshore Entitles Dodge Taxes on U.S. Stock Dividends*, Staff Report of the Permanent Subcommittee on Investigations, Car Levin Chairman (September 11, 2008).

that borrowing with the sale of a call option (guaranteeing that the taxpayer will in the future sell the stock at a fixed price and giving him cash today). They can use “kinked prepaid forward contracts” (which go under a variety of acronyms such as DECS) where they receive cash up front and give up variable portions of the return in specified ranges in the future. The possibilities are limited only by the imaginations of bankers and lawyers.

In a Haig-Simons or mark to market system, the hedge would not change the result. At the end of the tax period, the taxpayer would have gain or loss on the change in value of the stock, notwithstanding the hedge. To the extent the hedge changes in value, the taxpayer would have gain or loss on the hedge. But the fact that the two positions offset and therefore call ownership of the stock into question doesn’t affect the results. We only need to know values, not ownership.

When analyzing these transactions in our non-ideal tax system, however, we need to know whether the taxpayer still owns the stock. One approach, taken recently by the Tax Court (and discussed in more detail below) is to ask whether the taxpayer has the traditional indicia of ownership. We might think of ownership as a bundle of distinct rights, such as control, risk of loss, opportunity for gain, title, possession, and so forth and ask whether the taxpayer has a sufficient number of these rights to be the owner.

This is the approach used for physical property such as real estate. The most famous test is from *Grodt & McKay Realty*,¹⁸ which involved a dispute over whether the taxpayer owned cattle. The court used an eight factor test to determine the economic substance of the transaction. The factors included the risk of loss and opportunity for gain, possession, the obligation to pay property taxes, title, how the parties treat the transaction, and whether an “equity interest” in the property has been acquired.¹⁹

We suspect that under this approach, a taxpayer engaging in a short-against-the-box transaction would not be treated as the owner. The taxpayer has no possibility of gain or loss, and effectively gives up possession of the stock. None of the reasons we might want to have a realization-based system, such as liquidity or valuation concerns, apply. There is no economic substance of

¹⁸ *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981).

¹⁹ As we will see, the Tax Court has also used a similar 12 factor test from *Dunne v. Commissioner*, T.C. Memo 2008-63. *Dunne* was designed for stock ownership in a closely held corporation. It used similar factors, such as legal title, possession of stock certificates, the economic benefits and burdens of ownership, and whether the corporation lists the taxpayer as a shareholder on its books and records.

ownership left. Were the stock depreciable property in a sale-leaseback that had similar economics, there would be little doubt that the purported owner is not treated as an owner for tax purposes. Similar considerations, perhaps with different conclusions depending in the circumstances, would apply to other hedging transactions.

We say “suspect,” however, because we are not aware that this approach has ever been applied to a short-against-the-box transaction. Instead, as Kleinbard and Raskolnikov point out at length, ownership of fungible financial instruments is normally determined through a more formal analysis, where, if the taxpayer has something akin to title and the right to dispose of the financial instrument, he is treated as the owner notwithstanding that he has given up all of the economic rights.

There is a perhaps accidental twist in the law which is key to the analysis: we treat identical shares of stock (such as two shares of IBM common stock) as distinct for tax purposes even though they are indistinguishable. While this rule is perhaps a mere historical oddity with no justification, it provides the answer to the ownership question in the short-against-the-box transaction (assuming we follow the formal approach of assigning ownership to the person with title and the right to dispose). The taxpayer in a short-against-the-box is treated as borrowing other, identical shares to the ones he owns and selling those. Moreover, the taxpayer can always purchase and deliver different shares to close the short sale than the shares that he already owns. Therefore, he technically still has title to the shares and the power to dispose of them. Hence, Kleinbard and Raskolnikov conclude, the taxpayer is still the owner notwithstanding that he has no risk, no opportunity for gain, and has effectively cashed out of his position. Decades of tax law confirm this conclusion.²⁰

The focus on ownership, however, misses the most important tax results of the transaction. The tax law treats the hedged position completely differently than it does the unhedged position. Although this has happened over time and somewhat haphazardly, we can think of the tax law as going down the list of attributes that comes with simple ownership of stock and deciding how they should be treated for hedged ownership. Yes, we can still think of the taxpayer as owning the stock, but we make policy decisions about what ownership means in this context rather than slavishly granting the same consequences to ownership in

²⁰ See the discussions in Kleinbard, at 789, and Raskolnikov at 440-441.

all cases. Consider the following partial list of rules governing the tax treatment of hedged stock.

- *Section 1259.* Section 1259 taxes gain but not loss on sufficiently hedged positions through a constructive sale. The taxpayer is still the owner but the attribute “nonrealization of gain” is removed. (Losses are not allowed.) The precise contours of section 1259 were based on views about when it is appropriate to require realization of gain, not on when it is appropriate to treat a taxpayer as no longer owning the stock (because, after all, section 1259 treats the taxpayer as continuing to own the stock).
- *Section 246(c).* Section 246(c) denies taxpayers the dividends received deduction if they sufficiently hedge their stock. They are still the owner of the stock but cannot claim this attribute.
- *Section 1(h)(11).* Under section 1(h)(11), owners of stock may treat dividends as net capital gains. If, however, they hedge their risk of loss, they may not claim this attribute under rules similar to those that govern the dividends received deduction.
- Section 901(l) denies the taxpayer the foreign tax credit for taxes paid on dividends on sufficiently hedged stock under rules similar to those that govern the dividends received deduction.
- *Sections 1092 and 1233.* If the taxpayer does not already have a long-term holding period, sections 1233 and 1092 eliminate the taxpayer’s holding period without treating the taxpayer as a non-owner.
- Foreign taxpayers are still treated as an owner for purposes of determining whether dividends on the stock are subject to withholding.
- Taxpayers are likely treated as owners for purposes of determining whether a redemption of stock is treated as a dividend or a sale pursuant to section 302 and for most other purposes of subchapter C.
- Taxpayers appear to be treated as owners for purpose of the consolidated return rules.

It is clear from this list that ownership of hedged stock is treated completely differently from ownership of unhedged stock. Many but not all of the attributes assigned to owners of unhedged stock are not given to owners of hedged stock. While Kleinbard and Raskolnikov are correct that we treat an owner of hedged stock as continuing to own the stock, the statement has little functional meaning. Ownership is just a default rule for assigning tax attributes that we can and do modify as needed. An owner of hedged stock gets some attributes of ownership and not others. This is exactly what we should expect because determining which

attributes such a taxpayer should get will depend on the policy reason behind the attribute.

Non-ownership: exchange the share of stock for cash

Suppose that the owner of stock sells it. In general, this is a straightforward case of non-ownership. The taxpayer recognizes gain or loss and so on. Ownership seems to do the necessary work, and all one needs to do is determine whether the taxpayer ceases to own the stock.

The effects of a sale or exchange, however, are just attributes that we govern through various rules beyond ownership. In most cases, the attributes we assign to non-ownership are clear and the sale or exchange is sufficient to do the necessary work. In other cases it is not. For example, if a taxpayer sells the stock and within 30 days repurchases substantially identical shares, the wash sale rules treat a non-owner as an owner for purposes of one particular tax attribute, loss.²¹ Other attributes are not governed by the wash sale rules. The taxpayer is not an owner under the rules under subchapter C during the 30 day period. For example, during the period after sale and before repurchase, the taxpayer cannot count the stock toward control, the shares do not count as owned for consolidation, the taxpayer does not have continuity in the shares for purposes of the reorganization provisions, and so on.

The related party rules are similar. As a general matter, the taxpayer does not own stock that is sold to a related party. Nevertheless, the taxpayer is denied losses but is taxed on gains. Moreover, the taxpayer is treated as continuing to own the stock for some purposes, such as where section 318 applies.

Securities Loans and Repos

We close this section with a discussion of securities loans and sale-repurchase transactions (repos). These transactions, although quite old and central to the functioning of financial markets, present challenges to the analysis of ownership. For this reason, they are featured centrally in Kleinbard's analysis and we follow his analysis closely.

Securities loans. Securities loans typically take place as part of a short sale. A broker (with the client's consent) borrows a security from a client's account and transfers it to another client who typically sells it. The borrower has

²¹ The general wash sale rules are found in section 1091. Section 1092 has a related set of wash sale rules.

to put up collateral, which can be but is not always cash, and will receive a specified return on the collateral. During the term of the loan, the lender is entitled to receive payments equal to any dividends or other payments on the security (in lieu of payments) as if he were still the owner. When the transaction is closed, the security is returned to the lender and he must return the collateral.

The tax treatment of an almost identical set of flows, documented as a cash loan rather than a securities loan, is clear, although the labels are switched because the focus is on the transfer of the cash not of the security. In a cash loan collateralized by securities, party A receives cash from party B and transfers securities to B, to be held as collateral. When the transaction is closed, the cash and securities are returned to their original owners. In a cash loan, Party A is called the borrower and in a securities loan with the same flows, Party A is called the securities lender. The same reversal in terminology applies to B. Once one sees the reversal in the terminology, the similarity of the two transactions is apparent. In a cash loan, Party A, the cash borrower/securities lender is treated as continuing to own the security.

The problem with treating securities loans like cash loans is that in a securities loan, the collateral is normally sold and the person who buys the security outright in the market believes himself to be the owner. For cash loans secured by nonfungible property, this is not possible; a lender cannot sell a piece of real estate being used as collateral for a loan. If the cash loan is secured by fungible property such as securities, loan treatment is not a problem as long as the lender does not sell the property. If in a securities loan, however, we were to follow normal loan treatment on the stock lender side (who would be treated as the borrower in a cash loan), there would be two competing claims for ownership because both the original owner and the third party buyer would believe they own the security. Kleinbard concludes that because of this problem of multiple owners, we cannot treat a securities loan like an almost identical cash loan.

We agree with Kleinbard on this point but it is important to understand why the point is correct. Kleinbard argues that while many investors can have long positions in the security, there can be only one owner. Having multiple tax owners of a single piece of property, however, is not inherently bad. The problem with having multiple owners arises because ownership comes with specific attributes that we may not want duplicated. For example, if the security is a share of stock, we do not want multiple taxpayers to claim the dividends received deduction as there has been only a single distribution with respect to the stock

and, therefore, a need to prevent double taxation only once. That is, the problem the tax law faces with securities loans is attribute assignment.

The solution arrived at, as codified in section 1058, was to treat the securities lender as a non-owner during the term of the loan but to treat the transfer and receipt back of the security as nonrecognition transactions. The effect is to assign the ownership attributes to the third-party purchaser. If the security is a share of stock and pays a dividend, the third-party owner is treated as receiving the dividend. The in-lieu of payment received by the stock lender is treated as a contractual payment rather than a dividend receipt. There was little choice in this assignment of attributes because the third party purchaser likely has no idea that the security he purchased was borrowed rather than owned outright.

Kleinbard further argues from this treatment that securities loans are an example of non-ownership. While this is correct if one looks only to the formal treatment under section 1058, it misses other aspects of the transaction. For example, for purposes of computing unrelated debt-financed income of tax exempts, we treat the securities lender as continuing to own the security.²² Similarly, in lieu of payments are given the same source, character, and treatment under treaties as the underlying amounts they represent.²³

That is, we think of section 1058 as addressing the problem of dual claimants to certain attributes of ownership. It resolves these dual claims by treating the original owner as a non-owner, creating a default assignment of attributes. We then modify this default assignment where needed, such as for the source rules.

Repos. In a repo, an owner of a security – most typically a Treasury security or other relatively highly liquid debt instrument – needs cash to finance its business. It “sells” the security to a counterparty for cash and simultaneously agrees to repurchase the security in the future. The repurchase price is set equal to the current sales price plus an interest charge for the use of money during the term of the repo. Many repos are “overnight” which means that they have a term of a

²² Section 514(c)(8). A number of other rules specify the treatment of payments on securities loans for various purposes. For example, section 851(b) clarifies that payments on securities loans count as “good” investment income for purposes of the requirement that at least 90 percent of a regulated investment company’s gross income be investment income of specified types. Section 4940 holds that payments received on securities loans are investment income for purposes of the private foundation rules. These rules are not as clear as section 514(c)(8) that they are overriding the assignment of ownership to the ultimate buyer but they have a similar flavor.

²³ See Treas. Reg. sections 1.861-2(a)(7), 1.861-3(a)(6), 1.864-5(b)(2)(ii), 1.871-7(b)(2), 1.881-2(b)(2), and 1.894-1(c).

single day, but repos can also have longer terms, with the term being either fixed or indefinite.

Repos are classified for tax purposes (and for most other purposes, including regulatory and accounting) as secured loans. The original holder of the security is treated as continuing to own the security which means that no gain or loss is realized on the transfer to the third party or the transfer back from the third party. The attributes associated with the security are assigned to the original owner, not the third party.

The flows in a repo are identical to those in a securities loan. The owner of a security transfers it to a third party for cash at the start of the transaction and transfers the cash (plus interest) back to the third party in exchange for the security at the close of the transaction. Nevertheless, securities loans are treated as transfers of ownership for tax purposes while repos are not.

The difference between repos and securities loans has historical roots and also relates to the purpose for the majority of transactions. Securities loans are typically driven by a desire by a broker to gain access to a security. In most cases, the borrower sells the security and, as noted, there is a third party purchaser who holds it outright. The purpose of repos is typically dealer financing. A dealer with securities needs cash to finance its operations so it uses the securities to obtain financing. Repos are also used extensively by the Federal Reserve to manage the money supply.

The tax difference between repos and securities loans may have been driven historically by the difference in intent, but there is a separate policy reason for the difference. Historically, repos did not allow the security purchaser to sell the security, so there is no third party holder unlike for securities loans. This means that there is less of an attribute assignment problem, allowing repos to be classified as secured loans without fear that attributes would be taken into account by third party holders as well as by the original holder. That is, in the historical context (which is no longer the case as we shall see), the attribute assignment problem in repos was completely different than the attribute assignment problem for securities loans because of the lack of a third party buyer. As between the original securities holder or the temporary buyer, it was relatively easy to assign the attributes to the original holder in a repo, an assignment that is simply not possible for a securities loan.

Unfortunately, modern repos no longer have this key feature – no rehypothecation of the security – that differentiates them from securities loans. Under the standard form contract used for most repos, the repo lender is now allowed to sell the securities or otherwise use them in its business (such as repaying them out to obtain financing).²⁴ As Kleinbard relates, the Service apparently did not understand this when it issued a number of rulings on the tax characterization of repos, and the market did not understand the Service to be limiting its repo rulings to transactions that were not how repos actually worked. According to Kleinbard, “before anyone noticed, untold trillions of dollars of repos had been consummated – and been reported for tax purposes as money loans.”²⁵

If we strictly follow Kleinbard’s and Raskolnikov’s analysis, this latter feature has to mean that a repo that allows the buyer to sell the security is treated as a sale not as a secured loan; someone else has title and the right to dispose of the security. A number of consequences follow. If the transaction happens to satisfy section 1058, then the taxpayer recognizes no gain or loss on sale but the attributes associated with ownership are assigned to third party market purchaser. If the transaction fails section 1058, then the taxpayer will also recognize gain or loss on the sale as there will have been a realization event due to the transfer of ownership and no applicable nonrecognition provision.²⁶ As we will see, the holdings in *Anshcutz*, *Calloway*, and *Samueli* seem to imply that many term repos will in fact fail section 1058 which would mean that gain or loss is recognized for all term repos that allow the buyer to sell the security.²⁷ While there is no current movement toward legislation or regulation on this issue, if the problem of multiple owners becomes substantial, we suspect Congress will have to do something to address the problem. As will be discussed below, the best approach is not clear because the repo market is large and central to functioning of financial markets; changes in tax rules that hurt the repo market could be deleterious.

Conclusions

The pattern, we believe, should now be relatively clear. Ownership does not play a role in a pure income tax as all that matters is value. Our current

²⁴ See master repo agreement.

²⁵ Kleinbard at 798,

²⁶ If the repo is less than 30 days, however, loss may be disallowed under the wash sale rules, resulting in gain but not loss on a failed repo.

²⁷ In most cases, however, the gain or loss will not matter as most repos are done by securities dealers who are subject to market to market, but in some cases it could make a difference.

income tax uses ownership as a tool for assigning attributes or characteristics, such as holding periods, dividend, control, and so on. These attributes are used to calculate income and perform the other functions of our tax system. Ownership, in this light, acts as a default rule, a convenient start for assigning attributes. Because different attributes have different rationales and scope, however, we modify their assignment based on the particular context.

We turn to the consequences of this analysis below but first we describe three recent and important decisions on the ownership of fungible securities.

2. Recent court decisions

Ownership issues for fungible securities seem to have been relatively well settled and roughly followed the patterns laid out by Kleinbard and Raskolnikov, with some statutory modifications since they wrote. Three relatively aggressive transactions and the resulting Tax Court decisions, however, have thrown the analysis into turmoil. We review the decisions here.

Samueli

We start with *Samueli*, which is only partly about ownership, because it came first in time and because its holding on securities loans is needed to understand *Calloway* and *Anschutz*, which are directly about ownership.

Samueli appears to involve a complex transaction but its core economics were simple. It involved borrowing at short-term interest rates to purchase a long-term bond. If short term rates went down, the taxpayer would make money and if they went up he would lose money. The key tax aspect was that the transaction was structured so that the interest on the long term bond was treated as capital gain and deferred until realization through the use of a securities loan while the interest on the short-term borrowing was immediately deductible as interest expense.

The details are as follows. The taxpayer borrowed \$1.6 billion from his broker (yes, billion) and used it to purchase a stripped Fannie Mae bond (effectively just a zero-coupon, low credit-risk bond). The taxpayer then transferred the strip to the broker in a securities loan. The normal securities loan documentation was modified so that the taxpayer could not call the strip back except on specified dates. The reason for this modification appears to have been concerns about liquidity; if the taxpayer called back the strip on short notice, the

broker might have had a hard time locating an identical security to return to the taxpayer given the size of the transaction.

The broker put up \$1.6 billion as collateral on the securities loan, which was used to pay off the margin loan. The fee for the use of the collateral was the same as the interest on the margin loan so we can effectively think of the loan as still outstanding, just in another form. The taxpayer deducted the collateral fee as interest. He treated himself as not owning the strip during the term of the securities loan and instead, getting it back with its original basis. When he sold it, he reported the difference between the sales price and his basis as capital gain.

The abuse, if any, in the transaction was the treatment of the gain on the securities loan. To use simplified numbers, suppose that the taxpayer has a two-year zero coupon bond with a face of \$100 that will pay \$121 in two years. If he held the bond, he would accrue \$10 of interest income in the first year and \$11 in the second year. By lending the security and receiving it back immediately before the payment of \$121, the taxpayer is able to avoid the accrual of interest income because, after all, he is not the owner. He then receives it back with his original basis of \$100. By selling it for \$121, he can claim that the time value earnings are actually capital gain. By avoiding ownership via a securities loan, the taxpayer is able to convert currently included interest income into deferred capital gain.

The transaction was a real transaction in that the taxpayer made a bet on the movement of interest rates. Moreover the taxpayer actually made money on the transaction because short term interest rates went down. The collateral fee was \$40.6 million while the gain on the strip was \$50.7 million, creating a substantial net gain. For this reason, the government could not challenge the transaction as a sham.

The government's argument, which was adopted by the Tax Court and the Ninth Circuit, was that the securities loan should be disregarded because it violated the terms of section 1058 (discussed below). The transaction was effectively recast simply as a cash-settled forward contract to purchase the strip.²⁸ In particular, if the transfer of the strip to the broker was not protected by section 1058, then it must have been a taxable sale for the collateral put up by the broker. The obligation to return the security under the terms of the securities loan was, as a result, a forward contract for the purchase of the strip. This recharacterization

²⁸ The actual recast was somewhat more complicated. The government and the court treated the initial purchase and securities loan as a purchase and immediate taxable sale for the purchase price, generating no taxable gain or loss, plus the forward contract.

meant that there was no borrowing so the taxpayer could not claim the \$40.6 million interest deduction with offsetting gain in the strip. Instead, the taxpayer simply received the net gain as a single amount.

The government's argument, and the court's holding, therefore, comes down to whether the transaction met the requirements of section 1058. Section 1058 imposes three requirements to qualify as a securities loan (plus anything else the Service requires by regulation): the agreement must (1) require the return of identical securities; (2) require that in lieu of payments be made; and (3) not reduce the risk of loss or opportunity for gain of the original holder of the securities. The government argued that the fixed term of the securities loan reduced the opportunity for gain because the taxpayer could not recall the security and sell it for a gain in the event that its price went up. The Tax Court agreed.

This approach to securities loans is hard to justify. While this rule is a possible reading of the statute, it is not the only one and, in fact, there were good textual arguments against it.²⁹ It is not at all clear why term security loans raise tax policy problems any different from callable securities loans or term cash loans collateralized by fungible securities, neither of which is treated as a taxable event. Term securities loans may serve important market functions; if a security is not liquid, a borrower may desire a fixed term on the loan to avoid the potential for a short squeeze.³⁰ Moreover, the fixed term of the loan seems to have nothing to do with the issues presented by the case which are really about avoiding the original issue discount rules by avoiding ownership while retaining the economics. As a result, taxpayers will easily be able to structure around the court's approach by simply making the securities loan callable, at least for liquid securities.

The case, on the surface, is not about ownership as neither the taxpayer nor the government argued that the taxpayer owned the strip during the term of the securities loan. Moreover, the decision was based on a technical reading of section 1058, not on ownership. It fits the pattern described in Part I, however. The tax benefit in the transaction was the non-accrual of OID on the strip. Had the taxpayer been required to accrue OID, the Service would never have challenged the transaction. Non-accrual of OID on a strip during the term of a securities loan is a result of treating the taxpayer as not owning the strip under section 1058. That is the core tax rule focused too much on ownership and failed to make sure that the correct attributes were assigned to the taxpayer's position. A statutory fix to

²⁹ Discuss the section 514 rule which includes a rule requiring callable loans.

³⁰ Discuss the NYSBA report.

attribute assignment would have far better addressed the transaction than a narrow reading of section 1058.

In one sense, however, the case is a counter-example to our discussion. Our claim was that commentators and some courts, by fetishising ownership missed the way that the tax law actual functioned in the various difficult cases that they analyzed. Here, the tax law did not function properly. It did not assign attributes regardless of ownership, as we claim it normally does. It should have.

Calloway:

At its core *Calloway* simply involved borrowing in excess of basis. The taxpayer owned appreciated stock. To monetize the value without tax, the taxpayer entered into a three-year nonrecourse loan, secured by the stock, in an amount equal to 90 percent of the stock's value. The taxpayer had no ability to recall the stock and replace it with alternative collateral during the term of the loan. This alone would not likely have been challenged by the government as it is clear that borrowing in excess of basis does not result in a realization event.³¹ Unlike a normal collateralized borrowing, however, the lender in this case sold the collateral.³² The likely thinking behind the sale was that the taxpayer, in

³¹ Borrowing in excess of basis, without more, does not trigger gain. *Woodsam Associates Inc. v. Commissioner*, 16 T.C. 649 (1951), aff'd, 198 F.2d 357 (2d Cir. 1952).

³² The actual facts are considerably messier, and it is not clear from the opinion whether the transactions involved outright fraud or simply inadvertent but inconsistent reporting of the transaction. The lender, a company called Derivium, was in the business of marketing the transaction and was not an ordinary broker or lender. Derivium appears never to have any intention of holding the stock, and in fact it sold the stock prior to advancing the proceeds of the "loan" and based the loan amount on the sales price. From Derivium's perspective, the transaction looks like an ordinary sale fraudulently documented as a loan. Derivium does not, however, appear to have informed the taxpayer of the sale, and in fact sent the taxpayer account statements indicating that the taxpayer continued to own the stock. RICO claims by taxpayers against Derivium for misrepresentation resulted in a \$270 million judgment. <http://www.postandcourier.com/article/20090228/PC05/302289961> The Justice Department also obtained an injunction against Derivium from marketing the transaction. *U.S. v. Cathcart*, cite (N.D.Cal 2009).

Calloway, however, does not appear to be wholly innocent. He did not include on his tax return any of the dividends paid on the stock during the time he says he claimed he still owned it. Moreover, when the loan matured, the value of the stock was less than the face amount of the loan, so he surrendered the stock rather than pay the nonrecourse loan. Calloway did not include the face amount of the loan in the amount realized on the surrender of the stock, contrary to *Tufts*. Therefore, he seems to have taken the position that he did not sell it at the start of the transaction but yet did not own it during the transaction and did not have to report the sales proceeds at the end of the transaction even though at some point, either at the beginning or the end, he unquestionably sold the stock.

addition to borrowing against the stock, transferred the stock to the lender in a securities loan, making the transfer and the subsequent sale by the lender tax free under section 1058.

The question is whether the taxpayer had immediate gain from the disposition of the stock. The Tax Court majority approached the question by asking whether the transfer of the stock as collateral and the receipt of the loan proceeds should together be recast as a sale under the substance-over-form approach from *Grodt & McKay*. The court looked to whether legal title passed to the lender (it did), the parties' treatment of the transaction (they failed to consistently report it as a loan), and the "equity inherent in the stock" (which the court held was transferred). The court also found that the taxpayer had minimized his risk of loss because of the receipt of the nonrecourse loan proceeds. Although the taxpayer had the ability to pay off the loan and reclaim the stock, so that in theory the taxpayer had the opportunity for gain, the court treated this as an option to buy the stock rather than retention of the upside potential. Weighing these factors, the court found the substance of the transaction was a sale, not a loan.

Finally, the court looked to whether the transaction could be treated as a securities loan, effectively making the sale a non-taxable short sale by the lender. The court essentially relied on its holding in *Samueli* that securities loans cannot have fixed terms; the three year term meant that the taxpayer did not have the opportunity for gain because he could not demand return of the stock so that he could sell it for a gain.³³

The problems with the *Grodt & McKay* approach should be apparent from the discussion above and from a brief perusal of Kleinbard's and Raskolnikov's articles. It is inconsistent with the basic approach used for ownership of financial instruments such as stock. As noted, longstanding law holds that taxpayers who fully hedge their risk and eliminate their opportunity for gain are still treated as owning stock. Rather than a substance-over-form test, the tax law uses a more formal approach – title and ability to dispose, for example – to determine ownership of stock. While it could be the case that a substance-over-form test would be better than a formal approach (although we doubt it), the Tax Court did

To a great extent, these facts are distracting because the same or similar transactions could have occurred by parties acting in a more straightforward manner. We ignore the messy particulars in the text in an attempt to focus on the core issues presented by the case.

³³ The taxpayer in the face of the prior holding in *Samueli*, argued that the law of securities loans pre-dating the enactment of section 1058 applied to make the transfer non-taxable. The court rejected this argument.

not even acknowledge that its approach would change the law and would likely change the tax results of many common transactions.

Moreover, the formal approach to ownership is reflected in numerous provisions assigning tax attributes for hedged positions in stock. For example, section 1259, creating a constructive sale for sufficiently hedged stock, implicitly assumes that a taxpayer who fully hedges his stock continues to own the stock. The provision would not be needed otherwise, and the provision itself only creates a constructive sale to create realized gain, not non-ownership. The same holds for numerous other attribute assignment rules governing hedged stock, such as sections 1(h)(11), 246(c), 901(l), and 1092, all reviewed above. Therefore, even if a substance-over-form approach were superior to the formal approach, a substance-over-form approach is arguably inconsistent with the statutory rules.³⁴

Finally, a substance-over-form approach is not needed. If ownership is just a default rule for attribute assignment, the particular rules for each attribute can be modified if necessary. For example, section 1259 was written so that it did not cover nonrecourse loans in excess of the basis of fungible securities. Perhaps it should, although we do not take a view on this here. Assuming it should, there is no need to change the ownership rules for all attributes to ensure that taxpayers who borrow in excess of basis recognize gain.

Concurrences by Judge Halpern and by Judge Holmes took different approaches. Both judges argued that the test in *Grodt & McKay* was inappropriate for stock. Judge Halpern would have applied the approach described by Kleinbard and Raskolnikov, asking whether the lender had the power to dispose of the stock, which it did. This automatically creates a transfer, and the only question is whether the transfer qualifies for nonrecognition under section 1058, which Halpern would have held it did not because of the fixed term.

Judge Holmes would have instead relied on the rule in Treas. Reg. 1.1001-2(a)(4) that a nonrecourse loan is discharged by a sale of the collateral. While similar, the results under this approach could differ because the lender obtained the power to dispose of the stock the day before it actually did so. Halpern would have created a realization event when the lender obtained the power to dispose

³⁴ One may add that many of the *Grodt & McKay* factors are simply inapplicable to stock. For example, stockholders do not commonly pay property taxes on stock there is no deed to stock, and it is not clear what an “equity interest” in stock is. As we will note, stockholders typically do not have title and possession of stock. Judge Holmes makes these points forcefully in his concurrence.

while Holmes would have created a realization event only on the day of the disposition.

While both concurrences avoid the problems with the majority opinion, both raise serious problems. Halpern's opinion amounts to the assertion that the transaction was a failed stock lending because the taxpayer did not have the ability to demand the stock be return. As discussed above, it is not at all clear why fixed term securities loans should not get the same treatment as callable securities loans.

Holmes's opinion creates a problem any time a taxpayer lends margined securities. In particular, if a broker borrows margined securities from a customer's account and they are sold short, Holmes's opinion would tax the transaction. Section 1058, which normally treat this as non-taxable would not apply because Holmes's approach creates gain from the discharge of the liability not from the sale of the stock. Holmes even implies that this same result holds for recourse obligations. If true (we are not sure this would be correct even under his general approach), it would create problems for many repos.³⁵ If the repo is treated as a secured lending and the security is sold (as it often is), Holmes's approach taxes treat this as a discharge of the liability.

Overall, none of the approaches taken by the judges on the Tax Court is satisfactory. The technical approaches, those by Halpern and Holmes, have serious problems because they are either easily avoidable or create unnecessary collateral damage. The transaction in this case was simply sloppy, and better tax shelter provider could have avoided the problems raised by the technical approaches. The majority approach attempts to avoid these problems but introduces even worse issues because it uses a test that is wholly inappropriate to the context.

The reason all of the approaches are unsatisfactory is that they focus on ownership foot faults rather than the real concern raised by the transaction. The concern raised by the transaction is that nonrecourse borrowing in excess of basis is a way to obtain all or almost all of the benefits of a sale without triggering realization. That is, the problem is akin to section 1259; it is really one of deciding when a taxpayer has done enough to trigger realization of gain not

³⁵ See note 15 in *Calloway*. Repos appear to be recourse to the borrower. See _____. The issue is whether a sale of collateral discharges a recourse obligation. We are not aware of authority that treats this as discharge if the borrower remains primarily liable.

whether the taxpayer is still an owner. Perhaps the Tax Court judges were not free to revisit the rule that allows nonrecourse borrowing in excess of basis,³⁶ so they were left deciding the case on other grounds.

Anschutz

Anschutz is simply the high-rent version of *Calloway*. In both cases, the taxpayer hoped to effectively borrow against the value inherent in appreciated stock and eliminate much of the risk of ownership, while deferring tax. The mechanism in *Anschutz*, although it involved a bunch of complicated sounding derivatives, was essentially the same as the mechanism in *Calloway*. The taxpayer entered into a series of identically structured transactions using different shares of stock. In each case, the stock was sold under a prepaid variable forward contract (a PVFC, defined below), pledged to a third party collateral agent as collateral for the taxpayer's obligation under the PVFC, and transferred by the collateral agent to the buyer under a share-lending agreement (SLA). The three steps of the transaction were interdependent and incorporated into a master contract.

Under the PVFC, the taxpayer received cash equal to 75% of fair market value of the stock transferred. The PVFC had a maturity date of 10 to 11 years.³⁷ At maturity, the taxpayer was obligated to deliver a number of shares contingent on value at that time. The number of shares to be delivered was set so that the taxpayer received the first 50% of the appreciation during the life of the agreement gave up any appreciation above this amount. Under Rev. Rul. 2003-7, PVFCs generally fall outside of section 1259's constructive sale rules.

Under the master contract, the taxpayer was required to pledge to a collateral agent the stock sold under each PVFC. The collateral agent, in turn, was required to lend the stock to the taxpayer's counterparty under the SLA. Under the SLA, the taxpayer received a "prepaid lending fee" equal to 5% of the value of the borrowed stock. Thus, the total amount of cash received by the taxpayer at the beginning of the transaction equaled 80% of value of the stock (75% under the PVFC and 5% under the SLA).

The SLA allowed the counterparty to dispose of the stock, which it did almost immediately.³⁸ The SLA provided for a complicated payout schedule

³⁶ Woodsam, note _.

³⁷ The term in the particular transaction in *Anschutz* was set to avoid gain recognition under section 1341. Similar transactions entered into by other taxpayers had different terms.

³⁸ The borrowed shares were used to close out short positions the counterparty had taken immediately prior to entering into the transaction with taxpayer. The initial short sales were used

regarding dividend equivalent payments that “effectively transferred to [the counterparty] approximately 83%-88% of both the risks and rewards of the dividend payments associated with the pledged shares.”³⁹ Under the SLA, the taxpayer retained no voting rights in the pledged shares. Finally, the SLA provided the taxpayer with the right to recall the pledged shares. However, if the taxpayer exercised this right of recall, the taxpayer would be obligated to repay a pro rata portion of the 5% prepaid lending fee. The record on appeal stated that “under most scenarios” recalling the shares would “not be economically rational because of the cost,” a finding perhaps a tiny bit at odds with the facts of the case, seeing as the taxpayer actually did recall the stock.”⁴⁰

The taxpayer did not report any gain from the transaction, taking the position that the transaction was not a current sale under section 1001 and not a constructive sale under section 1259. The Service disputed the taxpayer’s characterization and argued that the transaction was a current sale (and in the alternative, a constructive sale).

The Service supported its current sale argument with an open-ended twelve-factor test for determining whether a transaction transfers the accoutrements of stock ownership. The Service contended that the SLA was not protected from gain recognition by section 1058 because it “did not conform with industry standards” and was not the type of liquidity-promoting stock loan Congress sought to promote by passing section 1058.⁴¹

The Tax Court held for the Service. In the Tax Court’s view, the PVFC and SLA were “clearly related and inter-dependent” and thus had to be considered together.⁴² The Tax Court attempted to determine the substance of the transaction, applying a facts and circumstances test from a case called *Dunne*. *Dunne* involved stock ownership but used factors similar to the *Grodt & McKay* factors. Using this test, the Tax Court found that the taxpayer had transferred “the benefits and burdens of ownership,” including legal title, all risk of loss, “a major portion” of the opportunity for gain, the right to vote, and possession.⁴³ Moreover, the Tax

to set the FMV of the stock for purposes of the transaction. It isn’t clear why the counterparty insisted on making the SLA part of the agreement (rather than hedging its risk by, for instance, keeping open its short position in the market).

³⁹ *Anschutz*, 664 F3d at 328, quoting from the record on appeal.

⁴⁰ 664 F3d at 328. The Tax Court wrote the stock recall off as an attempt to impress the tribunal with the legitimacy of the agreement. See 135 T.C. at 106 (“[T]he recalls were accomplished only the influence the tax analysis.”)

⁴¹ See 135 T.C. at 100.

⁴² 135 T.C. at 105.

⁴³ See 135 T.C. at 105-06.

Court held that the transaction did not qualify for nonrecognition under section 1058 because the upfront 75% cash payment limited the taxpayer's risk of loss and thus violated section 1058(b)(3). Taxpayer did manage a small victory regarding the amount of gain recognized in the transaction. The Service had argued that taxpayer must recognize gain equal to 100% of value, but the Tax Court disagreed and required the taxpayer recognize gain only to the extent the taxpayer received cash payments.⁴⁴ Finally, the Tax Court held that the PVFC was sufficiently kinked to avoid constructive sale treatment under section 1259, relying on Rev. Rul. 2003-7.⁴⁵

The Tenth Circuit affirmed on essentially the same grounds.⁴⁶ In considering whether the transaction was a current sale, the Tenth Circuit recited the eight-factor *Grodt & McCay* test relied on by the majority in *Calloway* (but not mentioned the Tax Court's opinion in *Anschutz*). The Tenth Circuit agreed with the Tax Court that the transaction did not qualify for nonrecognition under section 1058. The Tenth Circuit pointed out that in addition to reducing the taxpayer's risk of loss (and thus violating section 1058(b)(3)), the transaction did not provide dividend equivalent payments as required by 1058(b)(2).⁴⁷

The problems with the opinions in *Anschutz* are the same as the problems in *Calloway*. It is hard to understand how to apply a multi-factor test developed for physical property to fungible securities. Moreover, doing so would potentially over-turn well-established results and would be contrary to the basic approach taken by current law of using attribute assignment rules to determine the tax consequences of transactions in fungible securities rather than ownership. While the courts may have felt that the taxpayer in *Anschutz* should have had to pay tax on his gain given how he monetized the value and reduced risk, the approach taken in current law is to look to specific gain recognition rules, such as section 1259 rather than to inquire about ownership.

Said another way, perhaps section 1259 is unduly narrow and the taxpayer should not have been able to avoid it so easily. But given that it says what it says, it is hard to see how treating *Anschutz* as no longer owning the stock is the right approach given that a taxpayer in a short-against-the-box still owns the stock. Even though the taxpayer lost, the basic opportunity remains.

⁴⁴ See 135 T.C. at 108-09.

⁴⁵ See 135 T.C. at 109-13.

⁴⁶ See *Anschutz Company v Commissioner of Internal Revenue*, 664 F3d 313 (2011).

⁴⁷ 664 F3d at 331.

Summary

While one may have differing views about the proper outcome of these cases, it is apparent that the approach that they take to reaching the outcome is misguided. The court focused on ownership when the problems with the transactions are elsewhere. In *Samueli*, the problem is the failure of OID rules to tax term loans of an OID instrument. This problem has nothing to do with section 1058, which the court relied up for its holding. In *Calloway*, the flaw was the ability to borrow in excess of basis without tax. Other than the close to fraudulent facts surrounding the case, the facts are essentially the same as in *Woodsam* and the result no more offensive. In *Anschutz*, the flaw, if any, is the limited scope of section 1259 as well as the ability to borrow in excess of basis. It is hard to see how the transaction creates less of an ownership interest than a short against the box so deciding it based on ownership seems to miss the point. Instead, the relevant question for the court should have been whether section 1259 covers the transaction and for policymakers, whether the scope of section 1259 is appropriate. In all three cases, we can adjust the rules for tax attributes – OID, gain for borrowing in excess of basis, and 1259 – and not worry about ownership.

The Tax Court may have felt constrained because it believed it could only use the full ownership-hammer rather than the scalpel of correctly assigning a given attribute. Perhaps one way to prevent this from happening in the future it to allow the courts to ensure correct attribute assignment without altering ownership. This might be done through particular attribute rules – a given attribute rule may include discretionary language allowing a court to use judgment – or globally. The Tax Court then, for example, could have decided that the OID rules apply to lent Treasuries, producing the correct result in *Samueli* without changing ownership more generally, and similarly for the relevant attributes in *Calloway* and *Anschutz*.

All three cases also rely on a narrow reading of section 1058, a rule designed for attribute assignment in stock loans. Perhaps the Tax Court judges can be defended as mere scribes reading the statue and doing their job. Section 1058 just says what it says, and if Congress doesn't like it, they are welcome to change it. But this view has real problems. First, the reading of the statute by the Tax Court is unrelated to basic policy behind 1058 and is not mandated by the language of section 1058. Section 1058's construction of stock loans as involving non-ownership and nonrecognition are simply ways of ensuring attribute assignment. Lending transactions regularly have restrictions of the sort seen in these cases, so hard to see why they would trigger gain in the stock loan case

merely because of the mechanics of attribute assignment used in section 1058. Second, the Tax Court's reading of section 1058 creates problems because existing practice is contrary to the rule in the cases.

3. Proposal

The basic claim in the discussion so far is that ownership is simply a default rule for assigning attributes. Because the various attributes have different policy considerations, however, there is no reason to expect same assignment rules to work for each one and in practice, attribute assignment rules override the default rule and do so with considerable variation.

Given this structure of ownership – that it is just a default assignment of attributes – we suggest that the rule for ownership should minimize the costs of assigning attributes. To this end, we propose that a tax ownership for fungible assets that gets the assignment correct for the overwhelming majority of cases and that is clear, so that when attribute assignment rules deviate from the default, they do so based on a known-background rule. The rule that best achieves this follows the rules for legal ownership. As we will discuss, for street name securities, this no longer means title because of the use of street names. It means a UCC Article 8 securities entitlement. Where this ownership rule produces inappropriate results for some given attribute, the rules governing that attribute should override the default rule. This is similar to the approach described by Kleinbard and Raskolnikov, modified to take the street names into account (and with the strong emphasis, not found in those articles, that ownership is just a default for assigning attributes). Our proposal would reverse parts of the decisions in *Calloway* and *Anschutz*.

We first discuss the rules for legal ownership, then consider how they would apply in the tax context, and finally turn to repos and securities loans.

*Legal Ownership – Securities Entitlements*⁴⁸

Before turning to the legal framework for ownership, it is important to understand the mechanics. The key distinction in current law is whether a security is held directly or indirectly. If the security is held directly, the old distinctions

⁴⁸ Much of our summary is taken from Sandra M. Rocks and Carl S. Bjerre, *The ABCs of the UCC, Article 8: Investment Securities* (ABA, 1997), which contains a fuller discussion.

between certificated and registered securities remains. Most securities, however, are held indirectly, through brokers, clearinghouses, custodians, and nominees.⁴⁹

When a typical investor “purchases 100 shares of Microsoft” through a broker, the investor does not become the title owner of the stock. Instead, the investor receives a set of rights that look more like a contractual claim against his broker than property (although, as we describe below, there are property-like features). Typically the broker also holds the stock indirectly and therefore, only has contractual claims against someone else. The direct holder of many publicly-traded shares of stock is Cede & Co., the partnership nominee for The Depository Trust Company (DTC), a New York-based organization that provides clearing, settlement, and custodial services. Cede & Co typically holds a “jumbo certificate” to the shares and is the registered owner of the shares on the issuer’s books. DTC credits shares, by book entry, to the accounts of banks and stock brokers that hold shares indirectly through DTC. The banks and brokers in turn credit the accounts of downstream intermediaries or, finally, the investors at the end of the chain.⁵⁰

When one investor sells shares to another in the market, the stock certificate remains with Cede & Co. DTC and the other securities intermediaries simply debit and credit their book accounts as appropriate.⁵¹ The underlying security—and the direct rights against the issuer that come with it (voting and distribution rights being the two most important)—remain in the same hands. Since security intermediaries will often receive both buy and sell orders from their clients, trading orders are netted. The intermediaries shuffle their book accounts to reflect the trades. One entitlement holder’s rights are extinguished as another entitlement holder’s rights arise.

UCC Article 8’s 1994 revision was motivated by the desire to provide a legal framework for the commercial practices just described. One of Revised Article 8’s chief innovations was the concept of a “security entitlement.” Security entitlement is simply the name given to “the core of the package of rights of a

⁴⁹ In 1994, it was estimated that between 60% and 80% of public securities were held indirectly. See Prefatory Note, Proposed Final Draft (April 5, 1994), UCC Revised Article 8. Investment Securities, 2. Presumably the percentage is even higher today.

⁵⁰ See Sandra M. Rocks and Carl S. Bjerre, *The ABCs of the UCC, Article 8: Investment Securities*, 9 (ABA, 1997) (including a diagram that illustrates the indirect holding system). See also Prefatory Note, Proposed Final Draft (April 5, 1994), UCC Revised Article 8. Investment Securities, 2.

⁵¹ See Rocks and Bjerre at 47 (including a diagram that illustrates the mechanics of such a sale in the indirect holding system).

person who holds a security through a securities intermediary.”⁵² Thus, the person purchasing 100 shares of Microsoft purchases a securities entitlement, not the stock itself. Securities entitlements are an invention of the Article 8 drafters and do not conform to common law contract or property systems. Instead, the meaning of the term is “to be found less in any specific definition than in the matrix of rules that use the term.”⁵³

The most important component of that matrix of rules is the set of five duties Article 8 imposes on a securities intermediary with respect to its entitlement holders.⁵⁴ First, the securities intermediary must maintain financial assets corresponding to the security entitlements of its entitlement holders. Second, the securities intermediary must obtain dividends or other distributions made by the issuer, and pass those distributions on to the entitlement holder. Third, the securities intermediary must exercise rights with respect to the underlying security (such as voting or conversion rights) at the direction of the entitlement holder (who is free to delegate this power). Fourth, the securities intermediary must comply with orders by the entitlement holder, for instance to transfer or redeem the security. Fifth, the securities intermediary must act at the entitlement holder’s direction to change a security entitlement into another form of holding (for instance by causing a certificate to be issued to the former entitlement holder), or to cause the financial asset to be “transferred” to a securities account with another securities intermediary (transferred is in quotes since no actual transfer takes place; the securities intermediaries involved simply adjust their books to reflect the new indirect holding arrangement).

Under Article 8, the basic rule for when a person acquires a securities entitlement is very simple. A person acquires a securities entitlement when a securities intermediary credits a security to the person’s account.⁵⁵ A person holding a securities entitlement is known as an “entitlement holder.” Section 8-503(a) elevates the entitlement holder’s rights in the underlying asset, providing that interests in the underlying asset held by the securities intermediary are held “for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary.” As noted

⁵² Prefatory Note, Proposed Final Draft (April 5, 1994), UCC Revised Article 8. Investment Securities, 6.

⁵³ Id.

⁵⁴ See Rocks and Bierre at 48–56.

⁵⁵ See UCC § 8-501, prefatory note at 7.

above, the securities intermediary must comply with the entitlement holder's entitlement orders.⁵⁶

An entitlement holder wishing to transfer his interest in the underlying security (that is, a typical public shareholder wishing to sell his shares) has two options. One option is to instruct the securities intermediary (such as his broker) to engage in the transaction and make the resulting changes to its books and records to reflect the transaction. Once the intermediary has found a buyer, the shareholder's entitlement would be extinguished and a new securities entitlement would be created on the books and records of its intermediary. This process is known as originating an entitlement order.⁵⁷ The second option is to transfer the securities entitlement itself, which would require the shareholder to locate a buyer and then instruct the intermediaries to transfer the entitlement.⁵⁸

Tax Law Ownership

We propose the simplest possible default rule for ownership. For indirectly held fungible securities, the test for ownership should be simply whether the taxpayer holds a security entitlement in the security (and is not acting as a securities intermediary). If so, the taxpayer is the owner of the underlying securities for tax purposes. If not, the taxpayer is not the owner. For directly held securities, the test should be title. If the security is registered, the owner is the registered owner. For bearer securities, the owner is the person legally holding the securities. Finally, for non-security financial instruments, such as derivative contracts, neither party should be considered to own the reference security for tax purposes; each party should be considered the owner of its contractual rights against the other party.

The tax treatment of everyday investments would be unchanged by these rules. Most people consider themselves owners of the securities that they buy and are unaware of Article 8. Our proposal would treat them as the tax owners, as they are treated now. The treatment of hedged ownership would roughly follow the results described by Kleinbard and Raskolnikov. In particular, hedging, even perfect hedging, would not generally cause a change in ownership. Shorts-against-the-box, for example, would not result in a change in ownership (although they would result in gain realization).

⁵⁶ See UCC § 8-507.

⁵⁷ See UCC § 8-102(a)(7) (defining "entitlement order"); UCC § 8-507 (providing the securities intermediary's duty to comply with entitlement orders).

⁵⁸ In 1996, Prof. Schroeder wrote that transferring a securities entitlement was "unusual" in the context of repos.

The most important change from current law would be that the portions of the *Calloway* and *Anschutz* that looked to multi-factor ownership tests based on risk, return, and other factors would be overturned. (We will say more about the treatment of securities loans in those cases below.) Instead, ownership in those fact patterns would be determined based on who has the securities entitlement. In both cases, it appears that the taxpayer's securities entitlement was extinguished, so tax law ownership would be transferred as well.

To illustrate how our approach would apply, we consider a series of examples. We focus our discussion on indirectly held securities because most transactions now use this form. The treatment of directly held securities is similar and somewhat more straightforward because transfers involve actual transfer of legal title.

Unhedged ownership. In the most basic example, a taxpayer buys and sells shares of stock through a broker. Under Article 8, the taxpayer acquires a security entitlement when a broker credits shares to the taxpayer's account. Tax ownership coincides with the security entitlement so it continues for as long as the taxpayer continues to hold the security entitlement. When the taxpayer decides to sell its shares, it can either originate an entitlement order to that effect or transfer its security entitlement directly. In the ordinary case, the taxpayer originates an entitlement order (e.g., clicks "sell" on the broker's website). Completion of the sale extinguishes the security entitlement, terminating ownership for tax purposes. Other than being more precise about the mechanics of the transaction, our proposal is uninteresting in this context and does not change current law.

Precision about the mechanisms of securities markets, however, raises two issues that almost everyone would have thought were non-issues under any sensible tax system. The first is that transferring a securities entitlement from one intermediary to another technically extinguishes the original securities account/entitlement with the old broker while creating a new securities account/entitlement with the new broker. This would seem to create a realization event. Second, converting a securities entitlement to a directly-held security, which is permitted under Article 8 extinguishes the securities entitlement, again creating a realization event.⁵⁹ Neither of these events would seem to be an appropriate occasion for recognition of gain or loss (or other tax consequences from a sale, such as starting a new holding period). Section 1036, which provides for nonrecognition of gain or loss on exchange of common stock for common

⁵⁹ See Article 8-508.

stock in the same corporation, covers some of these exchanges but most likely needs to be expanded. (We do not quite understand how current law avoids these problems, although perhaps vagueness about what ownership means allows current law to pretend the problem does not exist.)⁶⁰

Hedged ownership. Where the taxpayer holds a security entitlement but hedges its economic exposure through a short against the box or forward contract, current tax law is somewhat uncertain as to whether the taxpayer remains the owner of the security, especially after *Calloway* and *Anschutz*. Under our proposal, the taxpayer's overall economic exposure would be irrelevant to ownership. What matters is whether the taxpayer retains his security entitlement. As long as the taxpayer retained his security entitlement, he would remain the tax owner of the security. If the taxpayer transfers his security entitlement or causes the security entitlement to be extinguished, he would generally cease to be the tax owner. Thus, a short-against-the-box would not affect the taxpayer's ownership. Similarly, a total return swap, where a taxpayer holds a security entitlement (or held stock directly) and accepts a cash payment in exchange for the taxpayer's obligation to make dividend equivalent payments and a subsequent payment based on the stock's change in value would not affect ownership.

Hedging ownership might be an appropriate occasion to collect tax on gain or loss (and/or to alter the taxpayer's various other tax attributes). We would make this determination through rules designed for the particular attribute at stake rather than by treating the taxpayer as no longer owning the security. For example, section 1259, perhaps expanded or narrowed as necessary, would govern whether gain is recognized when a taxpayer hedges its ownership. Section 246(c) would govern whether a taxpayer is entitled to the dividends received deduction for hedged ownership. Once it is clear that ownership is not capable of doing the necessary tax law work, these provisions might have to be reexamined and their scope extended as appropriate.

This approach would overrule the approach followed by the Tax Court in *Anschutz*. A forward contract would affect ownership only if the taxpayer ceased to hold a securities entitlement in the underlying shares. Under our approach the ownership discussion in *Anschutz* would have focused solely on the mechanics of

⁶⁰ Prior to the decision in *Cottage Savings*, it might have been the case that there was no material difference in having a securities entitlement against one intermediary as compared to having the entitlement against another. Cite. *Cottage Savings* would appear to change that rule because there is no question that the different securities entitlements are different legal entitlements as the counter-party is not the same.

the collateral arrangement. Whether, and to what extent, the delivery schedule for a forward contract is “kinked” would not be relevant to tax ownership. Kinks in the delivery schedule might well be relevant to whether the taxpayer is tagged with certain tax attributes—but that is a different question.

In *Anschutz*, the master agreement required the taxpayer to pledge the shares to a third party collateral agent who was required to loan the shares to the taxpayer’s counterparty (DLJ). The case reports state only that the shares were “delivered” to the collateral agent, transferred to DLJ, and used by DLJ to cover short sales. The case does not indicate whether the shares were held directly or indirectly, but the distinction does not matter. By transferring the shares, the taxpayer ceased to own them. Assuming the shares had been held indirectly, the transfer must have been the result of an entitlement order and have extinguished the taxpayer’s security entitlement. When the taxpayer subsequently exercised its right of recall, it acquired a new security entitlement.

The taxpayer in *Anschutz*, therefore, ceased to own the stock. Whether this is an appropriate occasion for the recognition of gain would depend on two issues. First, the transfer of the stock might be treated as a nonrecognition transaction under section 1058 or a possibly revised and expanded section 1058. (We discuss this below, where we consider the taxation of securities loans and repos under our approach to ownership.) Second, even if it is a nonrecognition transaction, it might be treated as a constructive sale of the taxpayer’s position in the stock (the taxpayer no longer owns the stock but would be treated as having a position in the stock) under section 1259 or a revised version of that provision.

Long non-ownership. Options and other financial products such as exchange traded notes allow taxpayers to take an economic position similar to actual ownership of a security without actually owning the security. Under our proposal, such a taxpayer would not be considered the tax owner of the underlying security unless and until the taxpayer holds the security directly or holds a security entitlement in the security. Constructive ownership rules, such as option attribution rules and section 1260 would apply, as appropriate, to treat derivative owners as having particular attributes.

Our approach would overrule the holding in Rev. Rul. 82-150. Rev. Rul. 82-150 treats a taxpayer with a deep-in-the-money option to purchase stock as owning the stock. The motivation behind the ruling was that the option attribution rules of the (then) foreign personal holding company rules did not work effectively. The Service, as a result, resorted to treating the taxpayer as the full

owner; it could not simply ensure that the correct attributes (inclusion of foreign personal holding company income) were assigned.

The Service's approach, we believe, is a mistake. The issue presented by the transaction was a narrow one, of ensuring that the taxpayer could not avoid the foreign personal holding company rules by using an option. The issue involved the assignment of a single attribute. The Service instead assigned ownership for all purposes, potentially overturning the approach used elsewhere in the tax law.

The IRS recently issued a general legal advice memorandum ("GLAM") holding that a hedge fund holding rights under "a contract styled as an option" in a basket of securities should be treated as the tax owner of the underlying securities.⁶¹ The contract allowed the hedge fund to determine the contents of the basket of securities. The hedge fund took the position that it owned an option, so that there was no realization event when it changed the underlying basket and as a result, when the option was finally terminated or sold, it would have long-term capital gain or loss. Had the hedge fund traded the securities directly, it would have had short-term capital gain or loss included currently.

Under the actual facts of the GLAM, the foreign bank appears to have held the basket of securities in a brokerage account for the hedge fund. If this is true, the hedge fund might have been the securities entitlement holder, in which case it would be the owner under our test. If, however, the option were just a general contractual arrangement with the bank where the bank hedged its position generally (say netting its short position in particular securities in the contract with other positions in its portfolio), the bank would not be the owner. The tax problem in this case is that section 1260 is effectively limited to constructive ownership of pass-through entities. To the extent that the government thinks that the taxpayer in this case should have short-term gain or loss, it should extend section 1260.

Loans of cash secured by securities One way of monetizing a position in a security is to pledge the security as collateral for a cash loan. If the loan is non-recourse, it protects the borrower against the risk that the security will decline in value (so that non-recourse borrowing is really a subset of "hedged ownership," discussed above). Under our proposal, whether such a transaction amounted to a disposition would depend simply on whether the taxpayer had given up its security entitlement in the security. Whether the taxpayer gives up its security entitlement depends on how the lender's security interest is structured.

⁶¹ GLAM2010-005.

Articles 8 and 9 of the UCC provide different ways of taking a security interest in “investment property” (an Article 9 defined term). Perfection can be accomplished by filing or “control”—with perfection by control taking priority over perfection by filing. A taxpayer can give the lender “control” over the security while remaining the entitlement holder. A party that has been given control may order the securities intermediary to dispose of the security without the consent of the entitlement holder.⁶² Under such an arrangement, however, the securities intermediary would remain obligated to comply with the taxpayer’s entitlement orders. Thus, a lender seeking even greater protection might demand to hold the security for the term of the loan. In this case the taxpayer’s security entitlement would be extinguished; the taxpayer would be left with only a contractual right to receive equivalent securities upon repaying the loan.

Under our proposal, the taxpayer has disposed of the security in the last arrangement because the taxpayer ceases to be the entitlement holder. (In the other cases, the taxpayer remains the entitlement holder so there is no disposition.) It may not, however, be appropriate to trigger gain or loss even in the last case as the parties likely view it as simply another version of a secured lending. Normal commercial arrangements of this sort are likely to fit under our proposed expansion of section 1058 discussed below.

The taxpayer in *Calloway* entered into a transaction styled as a non-recourse loan, but the Tax Court held that the transaction in that case constituted a disposition of the stock. The Tax Court’s majority opinion used an eight-factor analysis to reach its holding. Under our proposal, only one factor would be relevant: whether the taxpayer had given up its security entitlement in the security. The taxpayer in *Calloway* issued an entitlement order to transfer its shares, so would be considered to have terminated his ownership of the shares under our proposal.⁶³ Whether the taxpayer could claim that the disposition was a nontaxable securities loan is something we take up immediately below.

Repos and securities loans.

As noted, repos and securities loans have effectively the same cash flows but are treated differently for tax purposes. A repo is treated as a secured loan while securities loans are treated as dispositions that are granted nonrecognition

⁶² The Article 8 language is unclear here as it refers only to purchasers.

⁶³ 135 T.C. at 30 (“On or about August 9, 2001, petitioner instructed Brian J. Washington of First Union Securities, Inc., to transfer 990 shares of IBM common stock to Morgan Keegan & Co. and to credit Derivium’s account.”).

treatment. The historical difference seems to have been based on the market practice for repos that the lender retain the repoed securities and also the normal purpose behind the transaction. Financial markets have pushed the two transactions closer, particularly by eliminating the requirement that the same securities lent be returned in a repo. Modern repos allow the buyer to sell the securities and to return only equivalent ones. If, for this reason, modern repos are to be treated like securities loans, however, the recent Tax Court restrictions on section 1058 may make them taxable dispositions.

We consider here how securities loans and repos would be taxed under our proposal and examine the possibility of a unified regime for governing these transactions. Under our proposed ownership rule, ownership follows the entitlement holder, so the default treatment of both securities loans and repos would be as dispositions. The question is when this default treatment should be changed for each particular attribute that may be relevant. Our main goal is to suggest possibilities not to propose particular details; a full consideration of the policy details for each attribute would take us too far afield. We want to show how viewing ownership as simple default is consistent with reasonable treatment of common market transactions.

Before we begin, we should note that the background law is not fully coherent. Forward purchases of assets always involve an interest element in that they are economically equivalent to a current purchase plus a loan of the purchase price. For example, if a taxpayer agrees to purchase an asset currently worth \$100 for \$121 in two years, there is an implicit 10 percent rate of interest being charged for the deferred receipt of the money. It is effectively a two year loan (offset by the use value and storage costs of the property, if any, during the term).

The tax law as a general matter respects the form of forward contracts and does not impute interest on time value of money component.⁶⁴ The tax treatment of securities loans and repos depends on the tax treatment of forward contracts because they both involve an obligation to repurchase in the future. We cannot hope to fully rationalize the treatment of securities loans and repos when the tax treatment of forward contracts is not coherent. An important reason is that if a set of rules provides the desired tax treatment of securities loans and repos, taxpayers

⁶⁴ This can be particularly problematic when a corporation enters into a short contract on its own stock. Because section 1032 exempts gain or loss on a corporation's own stock, the implicit interest is not taxed. This can be combined with a borrowing to finance the position, generating deductible interest expense and nontaxable interest income. The IRS decided to bless this arbitrage in Rev. Rul 2003-97 for reasons that escape us. If there is one tax law change that comes from this article, it should be the revocation of this disgraceful ruling.

can always step outside these rules to get the background tax rule. There will almost certainly be discontinuities in the tax rules and a reasonable amount of electivity. Our approach, therefore, is to carve out a set of transactions where it is important that they be classified appropriately with the knowledge the falling into that set is to some extent voluntary.⁶⁵

To set the stage, consider an example. The first taxpayer, call him X, is the holder of a securities entitlement, so he owns them for tax purposes. X transfers the entitlement to a third party, Y, in exchange for cash and simultaneously the parties agree that the securities will be returned and the cash plus an interest charge paid back. Y may be restricted in its use of the securities, as in a classic repo, or may be able to rehypothecate them, as in a securities loan or a modern repo. If Y sells the securities, he sells them to Z who holds the securities entitlement and likely has no idea that X exists and is exposed to the economic risk from the securities. Z may now lend the securities to W terms and W may sell them to V and so forth, creating a chain of positions in the securities. Only the ultimate holder, say V, has the securities entitlement.

The place to start is with classic repos, where the purchaser of the security must hold the securities or identical securities. While repos with this restriction may be a small portion of the market, it may be appropriate to allow people to elect into this treatment by restricting rehypothecation. If there is no right to rehypothecate the securities, there are only two possible claimants to the attributes associated with the security, the original holder, X, and the new holder, Y and both parties are aware of the relevant transaction (i.e., there is no third party entitlement holder). We can, therefore, follow the traditional authorities and treat the transaction as a secured loan, assigning the attributes associated with ownership to the original holder X.

We can achieve this result by reaffirming the existing repo rulings, perhaps with the clarification that the purchaser must hold identical securities during the term of the transaction. Alternatively, we can provide a specific safe harbor through regulations, legislation, or perhaps a revenue procedure detailing the circumstances when this treatment is available. An alternative approach that is more consistent with treating ownership as a default rule based on securities

⁶⁵ An example of this from the accounting treatment of repos is Lehman Brothers's use of a "repo 105's". The accounting rules classified a repo as an on-balance sheet borrowing if the borrower promised to repurchase the security at a price between 98% and 102% of its value. By selling a security worth \$105 for \$100 and promising to repurchase it shortly thereafter, Lehman purposely failed the 98% limit, allowing it to treat the repo as a sale rather than a loan.

entitlements is to treat the purchaser as the owner but have a set of attribute assignment rules that gets to the same place as the existing rulings on repos.

Modern repos and securities loans present more of a challenge because if Y, the new holder of the securities entitlement can transfer it to a third party Z, Z will hold the securities entitlement and will inevitably claim the attributes associated with ownership. Z would believe himself to be the outright owner of the security and would likely be unaware that X owned the security previously and that X will eventually own identical securities. There are at least two possible approaches. The first is to follow existing repo treatment, treating the transaction as a secured lending, but ensure that attribute assignment is done correct. The second would be to follow existing securities loan treatment but ensure that the scope of this treatment is appropriate.

If we treat these transactions as secured loans, we would override our default ownership rule because X would be treated as the owner notwithstanding that he does not hold the securities entitlement. This would create two owners of the same security. This is not, however, a problem if we make sure that the attributes associated with ownership are properly assigned. If the attribute is one where it is important to assign only once, such as dividend treatment or tax-exempt interest treatment, there is little choice but to assign it to Z. Therefore, X would have to be denied these attributes notwithstanding treatment as a secured loan. If it is an attribute than can appropriately be assigned twice, such as the source of payments in the security, loan treatment does not create any problems.

While secured loan treatment would change the characterization of securities loans (effectively repealing section 1058), the overall treatment would be similar to current law. Under current law, taxpayers treat the interest charge on the collateral as creating interest deductions and inclusions and this treatment would be continued if securities loans were treated as secured loans. Similarly, current law has a complex set of attributes rules for in lieu of payments and these would be retained even if the transaction were treated as a secured loan; as always, attributes can be assigned independently of ownership based on the policies behind each particular attribute.⁶⁶

⁶⁶ One important difference is that the result in the transaction in Samuelli would be different. The taxpayer would be treated as still owning the strip so the taxpayer would have to accrue OID, as appropriate. This treatment, of course, could be provided even if a section 1058 approach similar to current law were used by requiring OID accrual on loaned debt instruments. Indeed, the NYSBA report suggests exactly this modification to current law. Cite.

Like with classic repos, treating these transactions as secured loans is a break from the normal rules for ownership and the normal treatment of forward contracts. We would, therefore, need to place parameters around this rule. In particular, we would want to ask when a deviation from the normal rules is appropriate. It is an exercise in line drawing between loan treatment and forward sale treatment.⁶⁷ There will be a discontinuity anywhere the line is drawn. The goal is to find a place where the discontinuity in the tax treatment least distorts transactions.

Regardless of where the precise lines are drawn, it seems hard to justify the restrictions imposed by the courts in *Samueli*, *Calloway*, and *Anschutz*.⁶⁸ In particular, there would seem to be no reason why transaction with a fixed term would not be allowed. A fixed term does not change the interest component of the transaction which arises because of the cash flows not whether they are fixed in time. A fixed term would also not likely affect the appropriate assignment of attributes, (although if it is important for a given attribute, the rules for that attribute can be modified as needed). There have been suggestions that fixed terms be allowed for securities loans for only a modest time period, such as three months, reflecting market practices.⁶⁹ It is not clear why there would be such a limitation given that loans may have a fixed period of many years.

There would also seem to be no reason why the original holder, X, could not hedge his exposure to the security, contrary to a broad reading of the holding in *Anschutz*.⁷⁰ There is no reason in general why taxpayers should not be able to hedge the risk of a security merely because they have also used it to secure a loan. It is conceivable that a section 1259-like rule would use as one factor whether the taxpayer has received cash or other consideration because the realization rule is in part based on liquidity considerations but the precise scope of such a rule should be based on the relevant considerations behind it (i.e., the reasons for realization and the economic costs of realization).

An alternative approach would be to expand section 1058 to treat modern repos as securities loans. The same basic considerations would apply. The approaches (loan or expanded section 1058) would merely be the technical means

⁶⁷ See Weisbach, Line drawing articles.

Mention repos to maturity and repo 105s?

⁶⁸ The restrictions in those cases related to section 1058, of course, but the broader policy question applies regardless of whether we choose loan treatment or section 1058 treatment for these transactions.

⁶⁹ NYSBA Report

⁷⁰ The NYSBA suggests a narrower reading of *Anschutz*.

at arriving at what should be the same results; the tax results should depend on the relevant policy considerations behind attribute assignment not the formal means of getting there. We would still recognize the interest component to the transaction and make the same attribute assignments. The main difference is that a section 1058 approach would treat the securities entitlement holder as the owner and recast the attributes in light of this default rule while the loan treatment would treat the original holder as the owner and recast the attributes in light of this approach.

Non-traded assets – sale leasebacks.

We close by briefly considering the treatment of nonfinancial assets under our proposal. Ownership has long been a vexing problem for depreciable assets because owners of such assets often want to assign depreciation to high-bracket taxpayers. Sale leasebacks are designed to achieve this. Indeed, it is not clear to what extent sale leasebacks would exist absent taxation.⁷¹ Determining when a sale-leaseback successfully transfers ownership is a vexing question and the answer has varied over the years.⁷²

A complete discussion of sale-leasebacks would take us far afield. We limit ourselves to two comments. First, our approach of thinking of ownership as a default rule supplemented by attribute assignment rules should work in the sale-leaseback context. We would treat the title holder as the owner but decide separately whether the conditions have been met for him to claim depreciation. We do this already to some extent under current law. For example, the passive activity loss rules and the at risk rules limit the attributes available to passive owners even if they are treated as owners for tax purposes.

Second, Professors Noel Cunningham and Deborah Schenk recently proposed an approach to ownership in this context that at least on the surface appears at odds with our approach.⁷³ They suggest finer grained division of ownership along with an accrual system designed to force recognition of time value of money returns. We view their approach as compatible with ours in the following sense: their approach moves the tax system closer to a Haig-Simons tax by forcing parties to recognize time value returns. By moving closer to a Haig-Simons tax, they reduce the problems ownership creates, and this is perhaps one

⁷¹ The question would seem to be the extent to which sale-leasebacks provide nontax treatment not possible with secured loans.

⁷² Frank Lyon, safe-harbor leasing.

⁷³ Noel B. Cunningham & Deborah H. Schenk, *Taxation Without Realization, A “Revolutionary” Approach to Ownership*, 47 Tax L. Rev. 725 (1992).

reason why their proposal is attractive. While we do not discuss ways to move financial products taxation closer to a Haig-Simons tax, to the extent the system moves in that direction, we suspect that ownership problems will be less important.

4. Conclusion

Our key point is that ownership acts in the tax law as a default for attribute assignment and nothing more. Given the default rule, the particular attributes are then tailored for the policies that are behind each attribute. There is no reason to expect uniformity and in fact we do not see uniformity. In this context, we want the default rule to be simple and provide the correct attribute assignment for ordinary cases. Detailed examinations of the attributes of ownership, as we done in recent cases such as *Calloway* and *Anschutz*, are not appropriate and only serve to muddle the role of ownership and make the law more complex than it needs to be.

We propose using the Article 8 securities entitlement rules as the default ownership rule for fungible securities held in street name and title for other assets. This provides the correct and intuitive answer for ordinary cases such as simple purchases or sales of stock or debt and provides a clear and simple background rule for other cases so that the attribute assignment rules can be written with an understanding of the default that they operate under.

Readers with comments should address them to:

Professor David Weisbach
University of Chicago Law School
1111 East 60th Street
Chicago, IL 60637
d-weisbach@uchicago.edu

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