

Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: March 18, 2013

to:
Financial Product Specialist

from:

(Large Business & International)

subject: Treasury Regulation 1.246-5(c)(6): Use of related persons or pass-through entities

This memorandum responds to your request for assistance dated February 12, 2013.
This advice may not be used or cited as precedent.

LEGEND

X –
A –
B –
C –
D –
\$Z –

ISSUES

Whether the S&P 500 options held by X are treated as a position held by the Related Party Subsidiaries pursuant to Treasury Regulation section 1.246-5(c)(6), thereby limiting the holding period of the subsidiaries' equity portfolio pursuant to Internal

Revenue Code (“IRC”) section 246(c)(4)(C) and denying a portion of X’s dividend received deduction (“DRD”) claimed under IRC section 243.

CONCLUSIONS

The S&P 500 options held by X are treated as a position held by the Related Party Subsidiaries pursuant to Treasury Regulations section 1.246-5(c)(6). Thus, the holding period of the subsidiaries’ equity portfolio is limited pursuant to IRC section 246(c)(4)(C), resulting in the denial of a portion of X’s deduction claimed under IRC section 243.

FACTS

X is parent company of the following four related entities: A; B; C; and, D (hereinafter these four related parties will be referred together as “Related Party Subsidiaries”). Each subsidiary is owned 100% by X. Furthermore, the Related Party Subsidiaries are part of an affiliated group of corporations, along with X, which files a consolidated tax return in accordance with IRC section 1501.

For the taxable year ending December 31, 2011, X reported on its US Tax Form 1120, Schedule C, receiving dividends in the amount of \$ from “less-than-20%-owned domestic corporations” and \$ from “20%-or-more-owned domestic corporations.” Furthermore, X reported a total DRD in the amount of \$ pursuant to IRC section 243. At issue is the portion of the dividends received (i.e. \$) from corporations which X purchased S&P 500 index options in order to hedge its exposure to fluctuations in the fair market value of these corporations. Thus, with respect to the total DRD claimed, only \$Z of X’s claimed DRD is at issue. The Exam Team intends to limit this \$Z DRD amount at issue by application IRC section 246(c)(4)(C).

In , X initiated a strategy utilizing put and call options on the S&P 500 index to hedge (on an economic basis) against price fluctuations of the equity security portfolio of X and Related Party Subsidiaries. Therefore, in entering these option positions, X knew that the assets being hedged consisted of the domestic equity portfolio accounts of the Related Party Subsidiaries.

In accordance with X’s strategy to protect against possible downside in the equity markets, X entered into a series of put and call options on the S&P 500 index. X is a writer and a purchaser of both puts and calls. These are cash settled options. The goal of the strategy is to give up some gain in order to protect against a downward slide in the stock markets.

The strategy, which was briefly summarized in the previous paragraph, was devised by a firm.

X agreed that its strategy to mitigate the risk of holding a portion of its equity portfolio by entering into over-the-counter options on the S&P 500 Index constituted a straddle under IRC section 1092. X also agreed that such stock was a type which was actively traded and at least 1 of the positions offsetting was a position with respect to substantially similar or related property, as defined in Treasury Regulation section 1.246-5. The portion of X's equity securities portfolio consisting of stocks which comprise the S&P 500 Index represents the "long position" in the straddle. The portion consisting of the purchased put options and the written/sold call options on the S&P 500 Index represents the "short position" in the straddle.

Taxpayer's Reasons for Strategy

X indicates that tax considerations were not sought, asked about or addressed in the establishment of the option program. X has provided the following business reasons to demonstrate that the affiliated entities did not hold the positions "with a view to avoiding the application" of Treasury Regulation section 1.246-5 or section 1.1092(d)-2:

- a.
- b. -
- c. -
- d. -

LAW AND ANALYSIS

A corporation is entitled to a dividends-received deduction of a percentage of dividends received from a domestic corporation that is subject to income tax. IRC section 243(a). As noted above, X claimed a DRD in the amount of \$ for dividends received by itself and the Related Party Subsidiaries.

No deduction is allowable, however, if the taxpayer did not hold the underlying shares of stock for a specified period of time. IRC section 246(c). Specifically, if the dividends are attributable to shares of stock, no deduction is allowed if the taxpayer held the stock for 45 days or less during the 91-day period beginning on the date that is 45 days before the date on which such share becomes ex-dividend with respect to such dividend. IRC section 246(c)(1). To determine the taxpayer’s holding period, the day of disposition but not acquisition is taken into account. IRC section 246(c)(3). However, the Code provides additional rules where a taxpayer’s holding period is reduced under certain scenarios where the taxpayer’s risk of loss is diminished for the underlying shares of stock. IRC section 246(c)(4).

Specifically, IRC section 246(c)(4) provides:

The holding periods determined for purposes of this subsection shall be appropriately reduced (in the manner provided in regulations prescribed by the Secretary) for any period (during such periods) in which—

- (A) the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities,
- (B) the taxpayer is the grantor of an option to buy substantially identical stock or securities, or
- (C) under regulations prescribed by the Secretary, a taxpayer has diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property.”

The Treasury regulations under section 1.246-5 provide that “[u]nder section 246(c)(4)(C), the holding period of a stock for purposes of the dividends received deduction is appropriately reduced for any period in which a taxpayer has diminished its risk of loss by holding one or more other positions with respect to substantially similar or related property.” Treas. Reg. section 1.246-5(a).

A “diminished risk of loss” occurs when a taxpayer holds positions with respect to substantially similar or related property, if changes in the fair market value of the stock and the positions are reasonably expected to vary inversely. Treas. Reg. section 1.246-5(b)(2). A “position” is defined as an interest in property, including an option. Treas. Reg. section 1.246-5(b)(3). Regarding IRC section 246(c)(4)(C), the Regulations elaborate:

The term substantially similar or related property is applied according to the facts and circumstances in each case. In general, property is substantially similar or related to stock when—

- (i) The fair market value of the stock and the property primarily reflect the performance of—
 - (A) A single firm or enterprise;
 - (B) The same industry or industries; or
 - (C) The same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates; and
- (ii) Changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property, a fraction of the fair market value of the property, or a multiple of the fair market value of the property.

Treas. Reg. section 1.246-5(b)(1).

Based upon X’s concessions, this memorandum assumes that (1) the options held by X represent a “position” as defined pursuant Treas. Reg. section 1.246-5(b)(3); (2) the options diminished the risk of loss with respect to the equity holdings of the Related Party Subsidiaries under Treas. Reg. section 1.246-5(b)(2); and (3) the options qualify as substantially similar or related property with respect to the stock under Treas. Reg. section 1.246-5.

Therefore, this memorandum addresses only the question whether the S&P 500 options held by X are treated as a position held by the Related Party Subsidiaries pursuant to Treasury Regulation section 1.246-5(c)(6), thereby limiting the holding period of the related parties’ equity portfolio pursuant to IRC section 246(c)(4)(C) and denying a portion of the taxpayer’s DRD claimed under IRC section 243.

Treas. Reg. section 1.246-5(c)(6) states, “[p]ositions held by a party related to the taxpayer within the meaning of sections 267(b) or 707(b)(1) are treated as positions held by the taxpayer if the positions are held with a view to avoiding the application of this section or §1.1092(d)-2.” X and the Related Party Subsidiaries are related parties under the definition of IRC section 267(b)(3) since all are members of the same control group.

X is the parent of an affiliated group that files a consolidated return, a group which includes the Related Party Subsidiaries. Upon entering these options, X knew that the positions offset the domestic equity portfolio accounts of the Related Party Subsidiaries and, in fact, entered into the option strategy in order to offset risk of loss in the equity portfolios. As a result, there are sufficient grounds to demonstrate that the positions were held with the view to avoiding application of IRC section 246(c)(4)(C). Even if X had other business reasons for hedging the assets of its subsidiaries in this manner, these business reasons do not alter the conclusion that the options were executed with the circumscribed purpose to diminish the risk of loss with respect to the stocks under section 246.

Accordingly, X’s options are treated as positions held by the Related Party Subsidiaries for purposes of applying IRC section 246(c)(4)(C). Thus, the holding period of the Related Party Subsidiaries’ equity portfolio is limited by IRC section 246(c)(4)(C); resulting in the denial of \$Z of X’s DRD claimed under IRC section 243.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call _____ if you have any further questions.

Associate Area Counsel
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By: _____

(Large Business & International)