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End Tax-Free Monetization of Wealth

By Calvin H. Johnson

Calvin H. Johnson is professor of law at the University of Texas. The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. By reasonable estimates, Congress must raise $4 trillion in revenue in the coming decade. The $4 trillion is hard news, but it can either be handled disastrously or with some wisdom. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project can be found at ''The Shelf Project: Revenue-Raising Projects That Defend the Tax Base,'' *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

This proposal would treat cash received for writing an option, a short sale, or future as boot or recognition of gain on the underlying property held by the taxpayer or a related party. If, however, the taxpayer does not yet own the underlying property, the cash received would be treated akin to borrowed cash and would not taxed until the transaction is completed.

The proposal is part of a series of proposals arguing that tax accounting reflects economic income only if a taxpayer's remaining basis reflects the value of the remaining investment. Adjusted basis should describe, as closely as possible, the net present value of the remaining investment.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

Cash withdrawn from appreciated property using financial instruments has become a major source of untaxed support for the standard of living of our wealthiest citizens.

The proposal would treat cash received under a contract for sale of property or for writing an option on property as realization of gain to the extent the taxpayer or a related party holds the property (or substantially identical property) with unrealized appreciation. If the taxpayer and related party have no gain on substantially identical property, however, the cash received would not be taxed currently, based on the reasonable presumption that the cash received will be offset by future repayments of cash.

Current Law

Cash received is not considered taxable gain if the taxpayer must make future repayments of cash that have an expected present value that offsets the cash received. Current law also inappropriately extends the exclusion to cash received for untaxed appreciation on property the taxpayer or a related party owns.

Borrowing. Borrowed cash is excluded from income because of the obligation to repay the loan plus interest. If a taxpayer borrows $100x, for example, the creditor tries to ensure that the amount to be repaid as interest and principal has an expected present value of at least $100x. The expected value of the repayments prevents the $100x receipt from being considered economic gain to the borrower. A taxpayer borrowing cash for profit aspires to make enough from the use of the borrowed proceeds to generate a profit above repayment, but future profit is not assured and has not been realized when the cash is borrowed.

Short sales. Cash received from a short sale of stock, or other property that the taxpayer does not own, is similarly excluded. In a short sale, the taxpayer borrows shares, usually from a broker, sells them for cash, and then must replace the shares, usually by purchasing shares to close out the transaction on the delivery date. A short sale is a traditional instrument that lets a taxpayer bet that the price of stock will go down — or at least not go up by more than the taxpayer's cost of capital. If the stock does better than the taxpayer's cost of capital, then replacing the shares makes the short sale an expensive way to borrow. Because the discount rate used to value stock is high to reflect volatility and other risks, a short sale on weighted average is likely to be a more expensive way to borrow than debt.

It has long been established that tax on cash received from a short sale is deferred until the borrowed stock is replaced.[1] The best rationale for that is similar to the rationale for exclusion of borrowed cash. When the short seller does not own the underlying stock, the taxpayer must purchase it for later delivery. The prices reflected in an efficient market are based on the premise that the

[1] Solicitor's Opinion 1179, *Internal Revenue Service, Cumulative Bulletin: Income Tax Rulings* at 60 (1919) (published before volume 1 of the Cumulative Bulletin) (short sale is not completed at time of the short sale because of uncertainty about gain or loss to be realized); reg. section 1.1233-1(a)(1) (1971) (a short sale is not deemed to be consummated until delivery of property to close the short sale).

current cash and later replacement have the same expected present value. The short seller is more pessimistic than the market price reflects about the prospects of the underlying stock, but none of the short seller's expectations are assured or realized when the cash is received.

The exclusion for cash received was extended by court and IRS interpretations to ''short against the box'' sales in which the taxpayer owns the underlying transaction.[2] A short against the box transaction necessarily has no net pretax meaning. Ownership and short sale of the same stock must offset each other — any gain from holding the stock is offset by the increased cost of replacing the borrowed stock, and any gain from the short position is necessarily offset by disappointing results from the long position of actual ownership. Except for tax, the short against the box transaction is just a chance to pay broker's fees. Even when the taxpayer *might* buy new stock to replace the stock borrowed for the short sale, the most reasonable expectation is that the taxpayer entered into the short sale to avoid realizing untaxed gain.

In 1997 Congress enacted section 1259 to make a short sale a constructive sale if the taxpayer held an appreciated position in substantially identical stock. Section 1259(c)(3) has an exemption that allows a one-year deferral of tax on cash received from a short sale — for example, on stock held for 60 days and closed in January of the following year — as long as the taxpayer is at risk for economic losses.

Writing of an option. Cash received for writing an option is not taxed when received, and tax is deferred until the option later lapses or is exercised.[3] If the option lapses, the taxpayer has short-term capital gain for the full premium received for the option.[4] No basis may be used to offset the option premium if the option lapses. If the option is exercised, the cash originally paid for the option becomes a part of the amount realized for sale of the underlying property.

If the taxpayer does not own the underlying stock, the rationale for exclusion of the cash received to write an option is much the same as the rationale for excluding cash from borrowing or a short sale. For example, the option purchaser pays $100x to buy an option because he expects the bargain he will achieve on exercise, multiplied by the likelihood of the bargain, is now worth at least $100x.[5] The taxpayer writing an option symmetrically can expect to have to buy the underlying stock paying more for the property than he gets from the option exercise by the bargain amount with the same likelihood. Because of arm's-length bargaining, the option buyer's premium and the option seller's obligation to satisfy the option each have an expected value of $100x. The option writer is more pessimistic in valuing the future bargains than the option buyer is, but the option writer's profit is neither assured nor realized when he pays for the option.

If the taxpayer doesn't own the underlying stock, the tax deferral for cash received from the writing of an option is a bit like the tax deferral for bookies — the bookie can take in a $100x bet on the fifth race, and we wait to see the outcome before deciding whether the bookie can keep the $100x or must pay back both the $100x bet and the payoff.

The exclusion for the sale of options has been extended to cases in which the taxpayer or a related party owns the underlying property with unrealized appreciation and will satisfy the call option when the other party exercises it, by delivering the property.

Forward Contract. A forward is a private contract to deliver a stock or commodity at a future time at the specified contract price. A futures contract is an exchange-traded forward contract using an exchange-mandated standard form to facilitate market evaluation and trade. Under section 1259, entering into a futures or forward contract is a constructive sale of the underlying property requiring realization of the untaxed appreciation, but under section 1259(d)(1), a forward contract that is a constructive sale must have a substantially fixed amount of property for a substantially fixed price. Forwards and futures are ordinarily executory contracts with no cash received by the seller until delivery. In Rev. Rul. 2003-7,[6] however, the IRS held that the taxpayer could receive cash under a *prepaid* forward contract for the sale of stock without paying tax on the cash received, when there was a 20 percent difference in the number of shares the taxpayer would deliver that depended on the market price of the stock at the time of delivery. A prepaid forward contract is different from a ''forward contract,'' under ordinary terminology, because of the cash received upfront.

Reasons for Change

Untaxed cash from monetization of untaxed appreciation is becoming an important but inappropriate means by which the wealthiest taxpayers maintain a high standard of living without paying any tax. Because of their untaxed wealth, counterparties to a financial transaction are willing to give wealthy taxpayers cash now in consideration for the purchase of property with unrealized

[2] *Bingham v. Commissioner*, 27 B.T.A. 186 (1932); Rev. Rul. 72-478, 1972-2 C.B. 487.

[3] *Kitchen v. Commissioner*, 353 F.2d 13, 15 (4th Cir. 1965); *Virginia Iron Coal & Coke Co.*, 37 B.T.A. 195, 198 (1938), *aff'd*, 99 F.2d 919, 921 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1939); Rev. Rul. 78-182, 1978-1 C.B. 265, 267 (ruling B1), *modifying* Rev. Rul. 58-234, 1958-1 C.B. 279, 283. Bruce Kayle, ''Realization Without Taxation? The Not-So-Clear Reflection of Income From an Option to Acquire Property,'' 48 *Tax L. Rev*. 233 (1993), is an excellent recent review of the law. Before Rev. Rul. 58-234 conceded the issue, the IRS ruled that the cash received for issuing an option was ordinary income to the issuer immediately. O.D. 1028, 5 C.B. 83 (1921); I.T. 3681, 1944 C.B. 64 (both revoked).

[4] Section 1234(b).

[5] In valuation of options by calculus, there is a large number of possible bargains assumed, each one multiplied by a likelihood of that bargain arising. A binomial model assuming that the property will have two states, one in which the option is not exercised and one representing the weighted average of all possible bargains, captures the logic of valuation of options.

[6] 2003-1 C.B. 363, *Doc 2003-1634*, *2003 TNT 12-13*.

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appreciation to be delivered in the future. In a coherent tax accounting system, appreciation does not offset cash, no matter when the appreciation is delivered, or no gain would ever be taxed.

Deferral of tax on cash received for unrealized appreciation reduces the economic tax rate below that mandated by sections 1 or 11. Even short-term tax deferral is unnecessary because the taxpayer has the cash in hand. Mark-to-market systems are said to be inadministrable because the taxpayer does not have cash to pay the tax, but in a monetization transaction the taxpayer has cash. The deferral allowed by current law, moreover, is not necessarily short-term. In a world of section 1014, where step-up in basis at death erases taxable gain, deferral usually becomes tax forgiveness. In the long run, everyone becomes eligible to pass property under section 1014. Consumption tax norms, which are becoming more influential, require diligent attention to ensure that cash consumed for high standards of living bears a high level of tax.

For some financial transactions, by contrast, the cash is not received for untaxed appreciation. The taxpayer has no economic gain because the taxpayer is obligated to return cash with an expected value at least equal to the cash received. If a taxpayer or a related party does not even own property with unrealized appreciation, it is fair to presume that the taxpayer's obligations to the other party to the transaction require future cash payments with an expected value that offsets the cash received. The writing of an option, a short sale, and a forward and futures contract are like a borrowing of cash; if the taxpayer does not own the underlying property because the taxpayer has the obligation to repay, that prevents the cash received from being properly considered an economic gain.

If there is ambiguity whether taxpayers will satisfy future obligations under a financial instrument by paying cash or transferring unrealized appreciation, the tax law should treat the untaxed appreciation as the item to be delivered:

- Tax accounting can identify the economic income from a property only if the accounting simultaneously maintains adjusted basis equal to the real investment value. If basis is below real investment value, then the tax accounting has not identified economic income. The real tax rate is then lower than the rates mandated by sections 1 and 11. Given a choice between an accounting system that maintains a low basis and one that maintains basis equal to value, only the latter is consistent with income tax norms.
- Unrealized appreciation is inconsistent with the general treatment of debt. If cash flows from debt and investment exactly offset each other pretax, then the combination of unrealized appreciation and the general interest deduction and use of borrowed proceeds will produce unjustified sheltering deductions or exclusions of consumed cash.
- A taxpayer has control over the decision to replace the transfer of property with the transfer of cash. Using cash in lieu of property is a discretionary investment made in the future. The decision can be adequately described by giving the taxpayer basis for the future cash once it is paid. Future contingencies under the taxpayer's control can be handled only by construing the contingency now against the taxpayer who controls it.
- In general, a transfer of property will be the cheaper decision. Cash is usually available to a wealthy taxpayer only after paying 35 percent tax or borrowing from someone who has paid 35 percent tax. Unrealized appreciation can usually be transferred with only a 15 percent tax.
- Withdrawal of cash from a productive investment for the purposes of personal consumption without tax is an abuse.

When the underlying property is a stock or commodity substantially identical to other stock or commodities, there is no meaning to a statement that a taxpayer will sell or will keep specifically identified stock or units. Cash, stock, and commodities are all liquid pools. Coherent tax rules need to have automatic stacking rules that give no credence to meaningless claims that cash is equal to some specifically identified thing within a liquid pool of fungible items. A rule that stacks cash to maximum gain will bring adjusted basis most closely to basis equaling the real investment value of the asset, which reflects the theoretical income tax ideal. Stacking to maximum gain is fully consistent with the economics of a liquid pool.

When the property is not a commodity or stock traded on a public market, then the specific identity of the property might make more sense, and the concept of substantially identical property makes less sense. Nonetheless, rules that cash received needs to be tied to specific property (for prepayments on contracts of sale, writing of an option, and short sales) do not make sense when daily price quotes are available.

Prepaid forward contracts. A forward or futures contract is usually an executory contract in which both the cash and stock will be delivered in the future. A *prepaid* forward contract, however, puts cash in the hands of the seller of the property. Section 1259 makes a futures forward contract a constructive sale of substantially identical property held by the taxpayer, but the constructive sale rules are based on protection from risk, and so section 1259(d)(3) makes a forward contract a constructive sale only if the contract sets a substantially fixed amount of property for a substantially fixed price. In Rev. Rul. 2003-7, the IRS ruled that the taxpayer could receive cash under a forward contract because the amount of stock to be delivered varied by 20 percent depending on the future price of the stock.

Allowing cash to be received under a prepaid forward contract without realization of gain is inconsistent with the claim of right doctrine:

> [The d]octrine, set out in *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 52 S.Ct. 613, 76 L.Ed. 1197 (1932), holds that funds received by a taxpayer will be considered to be [sales proceeds] income if (1) ''a taxpayer receives earnings under a claim of right'' and (2) ''without restriction as to its disposition,'' ''even though it may still be claimed that [the taxpayer] is not entitled to retain the money, and

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> even though [the taxpayer] may still be adjudged liable to restore its equivalent.'' Id. at 424, 52 S.Ct. 613.[7]

If a taxpayer has no disposition restrictions on cash sale proceeds, ''having commingled the funds instead of blocking them,'' and having ''placed itself in a position of complete dominion over those funds,'' the taxpayer recognizes the sales proceeds.[8] Similarly, it is said, the taxpayer

> ''has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.'' *North American Oil Consolidated v. Burnet*, *supra*, 286 U.S. at page 424, 52 S.Ct. at page 615. In such case, the taxpayer has 'actual command over the property taxed — the actual benefit for which the tax is paid.' *Corliss v. Bowers*, [281 U.S. 376].[9]

Consistently, in *Phillips v. Commissioner*, 262 F.2d 668 (9th Cir. 1959), the court held that the taxpayer had capital gain from the proceeds of the sale of stock received under the claim of right doctrine, even though the proceeds had to be refunded later.

Rev. Rul. 2003-7 inappropriately characterized the issue as whether a sale had taken place. The ruling cites a number of cases (including, for instance, a case on whether a sale-leaseback is a sham) that are not germane to the taxation of cash received. The factors cited by the revenue ruling include, prominently, whether title to the property has passed. Under the claim of right doctrine, however, title is an ''attenuated subtlety'' that cannot prevent cash received from being taxed.[10] Whether a sale has taken place might be relevant to whether cash received is a capital gain because it is part of a sale or exchange, but it is not a justification for not paying tax on the cash received in exchange for appreciated property. Sales can occur in many installments, each taxed. Rev. Rul. 2003-7, focusing on whether the sale had been completed, did not address the more important issue of how a taxpayer was entitled to cash held under a claim of right without paying tax on it.

Basis is recognized under section 1001, when amounts are realized from the cash. In Rev. Rul. 2003-7, there is a 20 percent variation in how much stock the taxpayer would deliver in return for the prepaid cash received. It was also unclear what cost basis would be identified to the stock that the taxpayer would deliver. Uncertainty about basis is not a principled ground for deferral of tax on cash the taxpayer has in hand. The general rule is that basis can include accrued or fixed liabilities to pay in the future, but not contingent liabilities.[11] The fundamental principle[12] is the all-events test, under which costs are not recognized for tax purposes until ''all the events have occurred to fix the liability and the amount thereof can be ascertained with certainty.''[13] The courts have emphasized that a liability does not accrue as long as it remains contingent.[14]

When there is uncertainty about the amount of the costs and the exact amount cannot be ascertained, however, that does not prevent the taxpayer from recognizing that portion of the total costs that *can* be ascertained.[15] Thus, in Rev. Rul. 2003-7 the taxpayer should get recognition of basis equal to the least basis of substantially identical property on hand that could satisfy the contract, and any higher cost should be recognized as a capital loss when the extra basis stock is delivered under the contract.

By contrast, if the taxpayer does not own property with appreciation substantially identical to the property sold under a forward or futures contract, then the taxpayer is giving up not untaxed appreciation, but future cash needed to satisfy obligations. The claim of right doctrine applies to transactions in which the taxpayer is receiving untaxed profit or sales proceeds, and not to transactions in which, like loans, the taxpayer will have to give back value as high as the value of cash received. In an efficient market, it is fair to assume that the cash and the future value of the underlying stock have the same expected value, so that the cash received under a prepaid forward contract is not gain if the seller does not yet own the property subject to the contract. If the taxpayer pays more than the prepayment received, or ends by paying less than the prepayment to buy stock to satisfy the forward contract, then the taxpayer will have gain or loss reconciling tax treatment to the overall cash situation at the time the contract is settled.

It is, however, easy to disguise what will in fact be a transfer of untaxed appreciation as if it were going to be a transfer of future cash, by holding property with built-in gain within another entity within the same economic group. Thus, in determining whether the cash is received for untaxed gain, any gain on substantially identical property held by a spouse or dependent, or related trust, partnership, or corporation needs to be treated as if owned by the taxpayer.

If the taxpayer or a related entity owns many blocks of stock that are substantially identical to the stock subject to the forward, then the all-events test mandates that it is the property with the least basis that is the noncontingent cost. The taxpayer would thus recognize the most gain

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[7]*Inductotherm Industries, Inc. v. United States*, 351 F.3d 120, 122 (3d Cir. 2003), *Doc 2003-26003*, *2003 TNT 236-9*.

[8]*Id.*

[9]*James v. United States*, 366 U.S. 213, 219 (1961).

[10]*Id.* at 216.

[11]*Albany Car Wheel Co. v. Commissioner*, 333 F.2d 653 (2d Cir. 1964).

[12]*United States v. Consolidated Edison Co. of New York*, 366 U.S. 380, 385 (1961).

[13]*United States v. Anderson*, 269 U.S. 422 (1926); reg. section 1.461-1(a)(2)(i) (1976).

[14]*Brown v. Helvering*, 291 U.S. 193, 200, (1934); *accord*, *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516, 519 (1944). *See, e.g.*, *Exxon Mobil Corp. v. Commissioner*, 114 T.C. No. 20 (2000), *Doc 2000-12483*, *2000 TNT 87-13* (the court allowed some expenses but disallowed others, depending on the certainty, clarity, and lack of ambiguity in relevant state law and agreements with state agencies).

[15]Reg. section 1.461-1(a)(2)(ii).

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possible of all substantially identical properties held by the taxpayer or related party. The most-gain rule would bring the taxpayer closest to the income tax norm that basis should equal real investment value.[16]

If less than the contract price is delivered at once, then only part of the taxpayer's basis is recovered against early partial payments. The rule for apportioning basis most consistent with income tax norms is that basis is never used until it is lost, and if the remaining payments yet to be paid exceed basis, then basis remains intact and all cash is apportioned to gain. Thus gain would be calculated on a partial sale, but after subtracting the maximum possible payment yet to come under the contract from basis and allowing recovery only of the remaining basis. No loss would be allowed, unless the maximum cash payable under all contingencies is less than basis.

Mark to market might be simpler for a taxpayer than an accurate inventory of all stock held by related parties, so a taxpayer would be entitled to elect mark to market if the underlying property is readily traded.

Writing of an option. If a taxpayer does not own the underlying property for which he has issued a call option, then it is fair again to presume — in bargaining between adverse parties in an efficient market — that the issuer has an obligation that offsets the cash received. Assuming the purchaser of the option pays a price for that option, determined by adverse bargaining, we are comfortable presuming that the writing of an option on property the taxpayer does not own is not economic gain. The option issuer's obligation to purchase the property to satisfy exercise of the option has an expected value equal to the option premium the taxpayer has received in cash (absent some indication the bargaining is not adverse and at arm's length).

If the taxpayer owns the property (or substantially identical property) subject to the option with built-in gain, by contrast, then the writing of an option is a realization of gain. An option holder pays for an option for profit, that is, for the opportunity to get the value of the underlying property that is higher than the exercise price of the option. The option seller is symmetrically selling the future values of the property that are higher than the exercise price. If the option exercise price is higher than the issuer's basis, the option price is allocable entirely to built-in gain. Exercise of the option is not a necessary presumption for cash received to be taxable, because if the option is not exercised, the price paid for the option is entirely gain. Because the option payment is immediate cash for untaxed gain, regardless of whether the option will be exercised, the claim of right doctrine requires that it be taxed.

The character of the gain — and, under some circumstances, the amount of the gain — will vary according to whether the option is exercised. If the option lapses, the writer retains the underlying property and retains the option premium as a kind of harvest or income from property not constituting a sale or exchange and not qualifying for lower capital gains rates. If the option is exercised, the option premium will be part of capital gain, assuming the underlying property is a long-term capital asset. If cash is taxed when received as the premium of the option, then it will need to be treated provisionally as either qualifying for capital gain or not, and then the character will need to be reversed if it is established that the provisional treatment was incorrect.

One alternative would be to determine the provisional character of the option premium by whether it is more likely than not that the option will be exercised. If the historical volatility of the underlying stock is known, then the likelihood of exercise, as used in the arm's-length bargain, can be deduced from the option premium, current price, and exercise price. Higher volatility of the underlying stock increases the option price and possible payoff, so it decreases the likelihood of exercise, all other things being equal. Another alternative is to avoid the option pricing formula that rests on volatility assumptions, and to treat small option premiums — say at under 20 percent of the exercise price — as ordinary harvest, provisionally, because a small option premium is an indication the parties thought that exercise was a speculative risk.

A final alternative, recommended here, is to treat the cash received as option premium as capital gain. The option premium is paid for by the purchaser for the opportunity to have the gain on the underlying property, not in lieu of periodic income. A worthlessness on lapse was not the point of the purchase. Lapse of the option is not under taxpayer control, so it can be recharacterized as ordinary income without suppressing elastic sales. Thus the option premium would be treated as long-term capital gain, if the underlying property is a long-term capital asset when the option is written. On lapse, if it occurs, the taxpayer would have short-term capital gain under section 1234(b), taxed at ordinary rates, and a (usually) long-term capital loss to reverse the prior capital gain.

If the exercise price of the sold option is greater than basis, the purchaser of an option is paying for the chance to buy what is entirely untaxed appreciation. If the exercise price is less than basis, however, basis needs to be allocated first to the exercise price, and then to determine gain. Recovery of basis up to the exercise price would be inappropriate because the issuer still has its investment or basis in the underlying property intact until exercise, and the exercise price ensures that the issuer will get back at least the exercise price. For example, if a taxpayer receives $25x for an option to purchase stock within a year for $100x, and the taxpayer has a $110x basis in the underlying stock, the taxpayer would have $15x gain on the writing of the option. If the option lapses, the taxpayer would have $25x short-term gain taxed at ordinary rates, and a $15x capital long-term capital loss to reverse the provisional but, as it turned out, erroneous treatment. If the option is exercised, the taxpayer will receive a total of $125x (the first $25x "installment" at the time of the sale of the option) on stock with a basis of $110x for a total gain of $15x, all of which has already been taxed.

[16]*See* Calvin H. Johnson, "End Identification of Stock Certificates," *Tax Notes*, June 16, 2008, p. 1171 (proposing to treat lot of stock with least basis as the stock sold).

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As with futures and forward contracts, substantially identical stock held by a related party in the same economic group as the taxpayer would be counted in determining whether the option is sold with respect to property held by the taxpayer. Mark to market would be available by election, instead of applying partial realization under the sold option rules.

Short Sales. Cash received from a short against the box transaction should be taxed when received. A short against the box transaction has no nontax business meaning because any gains from holding the underlying property are fully offset by losses from the short sale and vice versa. Section 1259(c)(3) gives a one-year tax deferral for some short sales closed by delivery within a month in the new year. Even a one-year deferral of tax of cash received is inconsistent with the fundamental claim of right principle, once the taxpayer has consumable cash in hand. Valuation of cash is never a problem. In general, the claim of right doctrine requires the taxpayer to pay tax on cash from gain when it is received.

If neither the taxpayer nor a related party owns property substantially identical to the stock that was sold short, by contrast, the taxpayer does not have gain from the transaction when the cash is received. The taxpayer's cash is offset by the expected present value of the cash that will be paid to purchase the stock to replace the borrowed stock that was sold, and there is no untaxed appreciation to be taxed when the cash is received.

A taxpayer may decide to close a short position by buying new stock and delivering the new stock instead of the stock with unrealized appreciation. That is a subsequent investment decision that should be handled like all similar future discretionary investments — the taxpayer gets basis for the investment when the investment is made. For example, if a short against the box is entered into at a price of $100x and the taxpayer has $2x basis in the property he holds, the taxpayer would have $98x gain on receipt of the cash. If the stock declines in value to $50x and the taxpayer decides to purchase stock at the current price ($50x) to effect delivery of the lent shares, the taxpayer will have $50x basis in the property retained, which is equal to the real investment value of the stock, as required by underlying income tax norms.

If the taxpayer has many blocks of stock that are substantially identical to the stock sold short, the all-events test would give the taxpayer immediate credit for the least possible basis that might close the sale.[17]

[17]Reg. section 1.461-1(a)(2)(ii) (the all-events test allows the minimum cost if the total amount is contingent). *See* Johnson, *supra* note 16 (proposing treating least basis stock as sold stock).

Proposed Legislation

Short sales. Cash received from a short sale of stock would be an amount realized on substantially identical property held by the taxpayer or a party related to the taxpayer under the rules of sections 267 and 707(b)(1). The substantially identical property with the least basis would determine the amount of the gain. The holding period would be determined by the substantially identical property with the least basis. No loss shall be recognized until delivery of the stock to complete the sale.

If the taxpayer completes the short sale by purchase of property, the stock the taxpayer retains after delivery would have a basis equal to that purchase price. Without regard to identification of shares, the property used to compute gain from the cash receipt on the short sale would be treated as the property delivered to close the short sale.

Writing of an option. A cash premium received for the writing of an option would be an amount realized on substantially identical property held by the taxpayer or a party related to the taxpayer under the rules of sections 267 and 707(b)(1). In computing gain, only basis of the substantially identical property in excess of the option exercise price would be offset against the option premium. The substantially identical stock with the least basis would determine the amount of the gain. The writing of an option would not produce a loss until the option is exercised at a loss.

If an option lapses, the option premium would be short-term capital gain, and the prior gain realized on sale of the option would be reversed by a loss of the same character and term as the gain recognized on sale of the option.

Forward Contract. Cash received under a forward or futures contract for sale of property, whether prepaid or not, would be an amount realized with respect to substantially identical property held by the taxpayer or a party related to the taxpayer under the rules of sections 267 and 707(b)(1). The gain would be calculated using the basis of the substantially identical stock with the least basis, resolving contingent terms of the contract to yield the least basis that would satisfy the contract. If the taxpayer incurs costs to satisfy a forward contract that are higher than the least basis allowed when the premium was received, the costs shall be allowed as a capital loss with the same term and character as the gain recognized on receipt of the cash.

If payments are received under a contract for sale of property, the cash would be an amount realized. Basis used against the cash received would be total basis less the highest possible cash that is yet to be delivered under the contract.

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