Temporary Treasury regulations address identified mixed straddle transactions

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In brief

On August 1, 2013, the IRS issued temporary and proposed Treasury regulations addressing identified mixed straddle transactions. The regulations prospectively preclude an investment strategy used by taxpayers to recognize built-in capital gains in order to offset capital loss carryforwards.

In detail

An identified mixed straddle is a straddle (that is, holding offsetting positions with respect to actively trade property) involving a Section 1256 contract (for example, a Treasury futures) and a non-Section 1256 contract (for example, a corporate bond) that is specifically identified. In recent years, taxpayers with capital loss carryforwards have engaged in identified mixed straddle transactions in order to recognize built-in capital gain in certain fixed-rate bonds for the purpose of offsetting their capital loss carryforwards. A taxpayer may choose to avail itself of the identified mixed straddle provisions by identifying the mixed straddle as an "identified mixed straddle" on the date the transaction creating the mixed straddle is executed.

Under the identified mixed straddle provisions previously in effect, the taxpayer was required to mark any built-in gain or loss on the identified bonds that were held prior to the date that the mixed straddle transaction was executed (for example, upon a taxpayer entering into offsetting Treasury futures). The new temporary regulations (promulgated as Treasury regulation Section 1.1092(b)-6T), which are effective for identified mixed straddle transactions entered into after August 1, 2013, provide that the built-in gain or loss is not recognized. Instead, the taxpayer must determine the amount of the built-in gain or loss at the time the transaction is executed for purposes of applying the remaining provisions of the identified mixed straddle rules, but the built-in gain or loss is recognized in accordance with general tax principles (that is, generally, under realization-based accounting).

The takeaway

The temporary regulations modify the treatment of identified mixed straddles that have been in effect for nearly 30 years. Moreover, legislative history to the straddle rules indicates that Congress intended a mark upon entering into a mixed straddle transaction. The new regime eliminates the mark in favor of realization based accounting for the built-in gain or loss. Interestingly, in its 2014 budget proposal, the Obama Administration expanded the application of the mixed straddle provisions and advocated a mark of built-in gain but not loss upon entering into a mixed straddle. It is not clear whether the new temporary regulations represent a reversal in Treasury's view of the merits of a mark of built-in gain as proposed in the President's 2014 budget.

The temporary regulations are prospective on their face, implying that, assuming the taxpayer complied with the identified mixed straddle provisions for previous transactions, the mark would not be challenged.

Finally, the temporary regulations do not address the Section 171 bond premium issue that often accompanied the identified mixed straddle transactions. This is not surprising because the Section 171 bond premium issue becomes moot for future identified mixed straddle transactions if gain is not recognized.

Let's talk

For a deeper discussion, please contact:

Financial Services

David Schenck, *Washington, DC*
+1 (202) 346-5235
david.a.schenck@us.pwc.com

Jeff Maddrey, *Washington, DC*
+1 (202) 414-4350
jeffrey.maddrey@us.pwc.com

David Shapiro, *Washington, DC*
+1 (202) 414-1636
david.h.shapiro@us.pwc.com

Michael Yaghmour, *Washington, DC*
+1 (202) 414-1317
michael.yaghmour@us.pwc.com