NOTES & COMMENTS

THE TAX-STRADDLE CASES

The use of commodity futures "straddle" or "spread" transactions to reduce tax burdens is a time-honored practice.[1] Because of their increased popularity over the past decade, tax straddles have recently received a great deal of attention from the Treasury Department[2] and from Congress.[3] The Treasury Department has issued revenue rulings disapproving of the practice[4] and has challenged thousands of tax returns in which taxpayers offset losses generated by straddle transactions against other income.[5] In the first case to reach trial, *Smith v. Commissioner*,[6] the United States Tax Court denied the straddle losses claimed by the taxpayers because the taxpayers lacked the requisite profit mo-

1. 12 TAX NOTES 209, 209 (1981) (testimony of Secretary of the Treasury Donald T. Regan at his confirmation hearing before the Senate Finance Committee (Jan. 6, 1981)).

2. *See* IRS, EXAMINATION TAX SHELTERS HANDBOOK, *reprinted in Silver Prices and the Adequacy of Federal Actions in the Marketplace, 1978-80: Hearings Before the Subcomm. on Commerce, Consumer and Monetary Affairs of the House Comm. on Government Operations*, 96th Cong., 2d Sess. 368-69 (1980) (hereinafter cited as *Silver Prices*); Lewis, *The Treasury's Latest Attack on Tax Shelters*, 11 TAX NOTES 723, 723 (1980).

3. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 501-509, 95 Stat. 172. This statute dramatically alters the tax treatment of commodity futures transactions by prospectively eliminating the claimed losses from tax straddles. Section 503 of the Act requires unrealized gains and losses in open futures positions to be valued by referral to their market prices on the last day of the tax year and to adjust taxable income accordingly. For straddle positions that do not consist entirely of regulated futures contracts, section 501 of the Act eliminates deductions for losses incurred in switching transactions so long as offsetting positions are maintained. Offsetting positions are broadly defined to include positions held in any actively traded personal properties that in combination substantially reduce the taxpayer's risk of loss from holding either individually. *Id.* § 501(c)(2)(A). Section 502 eliminates early deductions for interest and carrying charges allocable to straddles unless the straddles are hedging transactions. For a discussion of hedging, see text accompanying notes 27-29 *infra*.

4. Rev. Rul. 78-414, 1978-2 C.B. 213 (Treasury bills straddles); Rev. Rul. 77-185, 1977-1 C.B. 49 (silver straddles).

5. As of January 16, 1982 there were 1,002 tax cases involving commodity futures straddle losses docketed in the courts and 9,791 tax returns claiming such losses under audit by the I.R.S. The I.R.S. completed audits on 333 returns involving claims of futures losses during fiscal year 1981. Two hundred and seventy-five of the 333 taxpayers have appealed I.R.S. assessments for additional taxes totalling $8,130,969. Personal communication from Larry Batdorf, I.R.S. Nat'l Office (Jan. 26, 1982). Consequently, even without additional challenged tax returns entering the process, tax litigation concerning the treatment of futures straddles under the previous law has continuing importance.

6. [Regular Decisions] TAX CT. REP. (CCH) No. 38,835 (78 T.C. No. 26, March 5, 1982).

tive in entering the straddle transactions.[7] The court, however, rcognized the validity of the straddle as a legitimate transaction with economic substance despite the arguments of the Internal Revenue Service (IRS) to the contrary.[8]

Although the Economic Recovery Tax Act of 1981 has drastically altered the tax treatment of straddle transactions,[9] the validity of the transactions challenged in *Smith* and all cases involving disputed tax returns based on straddle positions acquired on or before June 23, 1981, will be decided under the previous tax law.[10]

The IRS first announced its intention to challenge the deductibility of losses generated in commodity futures straddle transactions by issuing Revenue Ruling 77-185.[11] Numerous tax commentators have questioned the soundness of the ruling,[12] and many taxpayers continued to use tax straddles until the passage of the 1981 legislation.[13] After an introduction to commodity markets and straddle transactions, this note reviews and criticizes both IRS's position in Revenue Ruling 77-185 and the Tax Court's holding in *Smith v. Commissioner*. This note goes further and suggests an alternative legal basis that recognizes the economic substance of straddle transactions and still allows courts to deny deductibility of claimed losses in situations in which the nominal losses do not reflect the taxpayer's true economic position.

---

7. *Id.* at 2850, 2874-76.

8. See notes 75-118, 159-80 *infra* and accompanying text.

9. See note 3 *supra*.

10. The new tax provisions are applicable to "property acquired and positions established by the taxpayer after June 23, 1981." Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 508(a), 95 Stat. 172. A significant amount of straddle trading continued until the June 23 deadline. *See Tax-Straddle Vote, Market Surge Coincide*, Wash. Post, Aug. 2, 1981, at H1, col. 1.

11. 1977-1 C.B. 48.

12. *See, e.g.*, Barbakoff & Sabin, *Are All Silver Transactions Created Equal? An Analysis of Revenue Ruling 77-185*, 56 TAXES 3, 5-6 (1978); Dailey, *Commodity Straddles in Retrospect: Federal Income Tax Considerations*, 47 BROOKLYN L. REV. 313, 325-42 (1981); Goldfein & Hochberg, *An Analysis of IRS' Ruling that Straddle Transactions Lack Requisite Profit Motive*, 47 J. TAX. 142, 142-47 (1977); Levin & Zucker, *Commodities Trading: How It Works and Can Save a Client Taxes*, 8 TAX. FOR LAW. 40, 44 (1979); Levy, *An Analysis of the Commodity Straddle as a Tax Planning Device*, 59 TAXES 467, 475-80 (1981); Schwartz, *Tax Opportunities and Problems of Investors in Options Markets, Commodities and Money Market Instruments*, 31 U.S. CAL. L. CENTER TAX. INST. 151, 178-80 (1979); Selig & Schmittberger, *Tax Aspects of Commodity Futures Trading*, 6 HOFSTRA L. REV. 93, *passim* (1977); Waite, *Futures and Taxes: Tax Spreads: Handle with Caution*, COMMODITIES, Oct. 1978, at 29; Waite, *Futures and Taxes: How Legal Experts View Key Issues*, COMMODITIES, Oct. 1978, at 33; Weinstein, *Commodity Straddles—A New Tax Battle*, 95 BANKING L.J. 70, 72 (1978); *Tax Straddles Under Federal Government Fire*, J. Com., Oct. 6, 1980, § 1, at 9, col. 4.

13. *See Futures Shock: Commodities Industry Is Irked by Bills to End Tax Break on Straddles*, Wall St. J., Mar. 25, 1981, at 1, col. 6 [hereinafter cited as *Futures Shock*].

I. THE COMMODITY MARKETS

Commodity futures contracts are traded in self-governed commodity markets called exchanges.[14] Rules that govern the exchange must comply with the regulations of the Commodity Futures Trading Commission (CFTC), set up in 1974 to expand government control over the futures industry.[15] Originally, only agricultural commodities were traded on the exchanges, but in the twentieth century commodity futures trading expanded to include nonagricultural-raw products, precious metals, and financial instruments.[16]

A. *The Futures Contract.*

Futures contracts, the basic instruments in futures trading,[17] can be bought or sold only on commodity exchanges.[18] Under the contract, the buying party is obligated to accept delivery of a standard quantity and quality of the commodity at the designated future date and price.[19] The buying party is said to take the "long" position on the contract. The selling party, who is obligated to deliver the commodity at the contract price, is said to take the "short" position. Once the contract is made, the buyer and seller deal with the exchange's clearinghouse, not with each other. Therefore, if the trader wishes to cancel or close out his futures contract before the delivery month, he need only enter the market and purchase an offsetting position. For example, if a person buys a futures contract for March delivery of 5,000 troy ounces of silver

14. G. GOLD, MODERN COMMODITY FUTURES TRADING 13 (1975); R. TEWELES, C. HARLOW & H. STONE, THE COMMODITY FUTURES GAME 23 (abr. ed. 1977) [hereinafter cited as FUTURES GAME].

15. *See generally* Rainbolt, *Regulating the Grain Gambler and His Successors*, 6 HOFSTRA L. REV. 1 (1977); Russo & Lyon, *The Exclusive Jurisdiction of the Commodity Futures Trading Commission*, 6 HOFSTRA L. REV. 57 (1977).

16. FUTURES GAME, *supra* note 14, at 5-11; Arak & McCurdy, *Interest Rate Futures*, 4 FED. RES. BANK N.Y.Q. REV. 33 (1979); Rainbolt, *supra* note 15, at 2-3, 14-15, 24-25; *Rapid Expansion of Financial Futures May Prompt Moratorium on New Issues*, Wall St. J., Mar. 25, 1980, at 38, col. 2.

17. *See* G. GOLD, *supra* note 14, at 13.

18. Throughout this note the following conventions are used: A person entering the market by buying a contract is called the buyer or the purchaser or holder of a long position. A person entering the market by selling a contract is called the seller or the purchaser or holder of a short position. Because the trader must pay cash to obtain either position, the word "purchase" is used to describe any transaction in which a person obtains a futures position of any sort—long, short, or straddle.

19. FUTURES GAME, *supra* note 14, at 23. Prices are arrived at in a continuous double auction of bids and offers occurring on the exchange floor during trading hours. At the end of the trading day, the exchange's clearing house substitutes itself as the opposite party on all contracts between buyers and sellers. The clearing house is, in essence, the buyer from all sellers and the seller to all buyers. From this point on, each trader deals with the clearing house, rather than with the original opposite trader. *Id.* at 27.

and then sells an identical contract at a later date, he is out of the market. His obligation to make delivery to the clearing house in March cancels his obligation to accept delivery from the clearinghouse in that month. Over ninety-eight percent of all futures contracts are settled this way rather than by actual delivery.[20]

B. *The Concept of Margin.*

The concept of margin has a fundamentally different meaning in commodity futures trading than it does in securities trading. In securities trading, the margin represents a partial payment by the ultimate buyer to the broker for stocks or securities. Because the buyer eventually must pay the full amount of the purchase price to the seller, the margin account shows a debit that reflects the amount of the purchase price financed by the broker. The size of the debit is limited by the Federal Reserve, the stock exchange, or the broker himself.[21]

In contrast, the margin in commodity futures trading is not a loan but a good-faith deposit, ensuring the ability of the contracting party to fulfill his obligations[22] and protecting the broker from adverse price changes while the contract is open.[23] For example, the amount of cash required to purchase a contract to deliver silver does not depend on the price of silver but on the probability that a change in the price before delivery will require the investor to purchase the silver at a higher price than the contract price at which he is obligated to deliver the silver.

The exchange may set minimum margins, but a broker may require additional amounts if he believes the risk of adverse price changes warrants it.[24] Margin requirements of five or ten percent of the contract value are common. In low-risk positions, such as certain straddles, the amount may be even less.[25]

20. *Id.* at 24.

21. *Id.* at 17.

22. The futures contract and the accompanying brokerage agreement obligate the purchaser of a commodity futures contract to do two things. First, in accordance with exchange standards, he must deliver or accept delivery of the commodity during the contractual delivery period. Second, he must respond to significant adverse daily price changes with a cash payment to his broker. The broker is, in turn, obligated to respond to a call for cash from the exchange clearinghouse. FUTURES GAME, *supra* note 14, at 23-24.

23. *Id.* at 17-18. A contract is open until the trader purchases an offsetting position or delivery of the commodity eliminates or closes the contractual obligation.

24. *Id.* at 18.

25. *Id.* In fact, from May 19, 1975, until September 18, 1979, the Chicago Mercantile Exchange clearinghouse required no margin on silver straddles for the first 500 contracts. R. Gray, Report on Risk and Profit Potential of Spreads and Butterfly Spreads in Silver Futures 11 (Oct. 17, 1980) (unpublished report submitted to the U.S. Tax Court by the IRS in Smith v. Commissioner, [Regular Decisions] TAX CT. REP. (CCH) No. 38,835 (78 T.C. No. 26, March 5, 1982)).

Because margin requirements are low, an investor can purchase a relatively large number of futures contracts with a modest cash outlay. A large number of contracts multiplied by even small variations in the price of a commodity can create dramatic gains or losses for the investor. The commodity futures investor, however, risks more than his initial investment. A broker may require additional margin deposits in amounts greatly exceeding the initial margin investment because of adverse price changes in the commodity.[26]

C. *The Participants.*

The traditional market traders can be divided into two broad categories: hedgers and speculators.[27] Hedgers are usually manufacturers, merchants, dealers, or producers who have an interest in protecting themselves from price changes in the commodities that are an integral part of their business or trade. A hedger may wish to protect the value of his inventory from declining prices by selling futures contracts in the commodity that constitutes his inventory. Any decrease in the value of his inventory will then be offset by a corresponding increase in the value of his short position in futures.[28] Losses and gains from futures contracts in the hands of hedgers are considered ordinary losses and gains for tax purposes.[29]

Speculators include members of the public, commonly called investors or speculators, and floor traders trading on their own accounts, commonly called locals or scalpers. Speculators seek to profit from a price change in a given commodity.[30] They are not interested in obtaining the underlying commodity but may occasionally take delivery if a discrepancy between the cash market price and the futures price makes it profitable.[31] Commodity futures in the hands of speculators are treated as capital assets for tax purposes.[32]

---

26. Because of the risk of margin calls made necessary by adverse price movements, see notes 22-23 *supra* and accompanying text, the initial margin deposit should not be considered the total investment required except for certain straddles held for very short periods of time. *See* D. Breeden, Variability in Gold and Silver Futures Spreads 20-34 (Mar. 1979) (unpublished paper on file in the Duke Law Library).

27. Selig & Schmittberger, *supra* note 12, at 94.

28. *See* FUTURES GAME, *supra* note 14, at 29-31. This definition of hedging is generally accepted, but it is somewhat naive—many hedgers are in reality hedger-speculators.

29. *See* Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 52-53 (1955).

30. Selig & Schmittberger, *supra* note 12, at 94.

31. FUTURES GAME, *supra* note 14, at 28-29.

32. Commissioner v. Covington, 120 F.2d 768 (5th Cir. 1941), *cert. denied*, 315 U.S. 822 (1942); Muldrow v. Commissioner, 38 T.C. 907 (1962); I.R.C. § 1221; Rev. Rul. 78-94, 1978-1 C.B. 58; Schwartz, *Tax Opportunities and Problems of Investors in Options Markets, Commodities and Money Market Instruments*, 31 U.S. CAL. L. CENTER TAX INST. 151, 170-74 (1979).

D. *The Straddle Transaction.*

A futures contract purchaser is said to have a net long position if his long positions in a commodity exceed his short positions in the same commodity. Conversely, if his short positions exceed his long positions in the commodity, he is in a net short position.[33] If the purchaser has equal amounts of futures in the same commodity that are long in one month and short in another month, he is said to be in a straddle or spread position.[34] The purchaser "buys" a long or "bull" straddle if he is long in the more distant month's contract and the purchaser "sells" a short or "bear" straddle if he is short in the more distant contract.[35]

When the purchaser straddles between months in this manner, he has a time straddle. A trader can also straddle between different markets or between related commodities.[36] However, equal long and short positions in the same commodity, in the same market, and in the same month are not straddles; they cancel one another out.[37] The straddles that tax-motivated investors use are usually time straddles, although they also may be intercommodity or intermarket straddles.[38] In time straddles, the investor's risk of loss and chance of profit from price changes in the commodity are substantially less than the risk incurred by the investor with a net long or short position. For instance, the loss that a short contract incurs when the price of the commodity rises substantially requires a net short-position investor to increase his margin. The net long-position investor enjoys an equivalent gain. The straddle investor incurs no net gain or loss because the loss his short position incurs is offset by the gain to his long position.[39] This reduced risk of loss is reflected in straddle margin deposits, which are substantially lower than those required for indentical contracts purchased as net positions.[40]

33. FUTURES GAME, *supra* note 14, at 28, 217.

34. *See* Powers, *Fact and Fiction About Spreads*, COMMODITIES, July 1973, at 41; Schwager, *Understanding Spreading*, COMMODITIES, Oct. 1974, at 10.

35. Ginsberg & Seidel, An Analysis of Select Comex Silver Futures Trades 6 (Oct. 22, 1980) (unpublished paper prepared for the IRS and submitted by the IRS to the Tax Court in Smith v. Commissioner, [Regular Decisions] TAX CT. REP. (CCH) No. 38,835 (78 T.C. No. 26, March 5, 1982)).

36. FUTURES GAME, *supra* note 14, at 216-23; Schwager, *supra* note 34, at 11-12.

37. See text accompanying note 20 *supra*.

38. *See Futures Shock*, *supra* note 13, at 25. Any market combination usable for speculative straddles can be used for tax straddles.

39. *See* FUTURES GAME, *supra* note 14, at 33. The offset is not perfect, however. See notes 40-46 *infra* and accompanying text.

40. Tiger, *The "Limited-Risk" Spread*, COMMODITIES, July 1974, at 15.

The purchase of a straddle is not, however, a risk-free transaction. Even though losses or gains incurred by either leg of the straddle as the price of the commodity fluctuates are of no economic consequence to the investor—tax claims aside[41]—actual profits and losses in straddles do occur when the differential in commodity futures prices between the different delivery months of the straddle narrows or widens.[42] These price differentials depend on the cost of storing and insuring the commodity and on the cost of borrowing money to finance the purchase of the commodity.[43] For perishable or seasonal commodities, the price differences also reflect anticipated surpluses or shortages in the different months.[44] With nonperishable commodities, for which supply is not a consideration and storage costs are low, the straddle differentials primarily reflect current interest rates.[45] When the price differential between the two months increases, a long straddle profits and a short straddle loses; the reverse occurs if the price differential decreases.[46]

On a per-contract basis, straddles involve less risk than net positions in the same commodity. Lower straddle margin requirements reflect this lower risk, however, and allow a trader to purchase more straddle contracts than he could net contracts with a given investment. Thus, when measuring the total risk as a percentage of invested equity rather than as risk per contract, straddles are often potentially as profitable as the corresponding net positions.[47] In fact, when profits are measured in this way, straddles often outperform net positions.[48]

E. *Offsetting Straddles—The Butterfly Straddle.*

A short straddle and a long straddle can also be offset against each other in a "butterfly" straddle.[49] A butterfly straddle consists of long positions in the nearest and most distant month bracketing an equal number of short positions in an intermediate month or vice versa.[50] An example is a short March/May straddle offset by a long May/July straddle.[51] The two short positions in May create the "body" of the

41. These fluctuations are, however, of primary interest to the tax straddler. See text accompanying notes 57-60 *infra*.

42. Riess, *Arbitrage as a Trading Medium*, COMMODITIES, Mar. 1973, at 24.

43. *See* Powers, *supra* note 34, at 42; Schwager, *supra* note 34, at 13.

44. *See* Powers, *supra* note 34, at 42; Schwager, *supra* note 34, at 12-13.

45. Jacobs, *Before You Trade Spreads, Beware . . .*, COMMODITIES, Dec. 1974, at 32-33; Schwager, *supra* note 34, at 10-11; see note 53 *infra*.

46. Schwager, *supra* note 34, at 10-11; R. Gray, *supra* note 25, at 19.

47. Tiger, *supra* note 40, at 15.

48. *Id.*

49. Ginsberg & Seidel, *supra* note 35, at 7; R. Gray, *supra* note 25, at 18.

50. Ginsberg & Seidel, *supra* note 35, at 7-8; R. Gray, *supra* note 25, at 18-20.

51. For a definition of short and long straddles, see text accompanying note 33 *supra*.

butterfly, the long March and long July positions its "wings." The intervals between delivery months need not be equidistant, although equidistance is required for the two spreads to offset interest rate changes perfectly.[52] Butterfly straddles, whether perfect or imperfect, significantly reduce the risks and the profit potential present in simple straddles.[53]

II. Claimed Tax Advantages of Straddles

Straddles are composed of individual futures contracts that, although obtained simultaneously as parts of a straddle,[54] are identical to contracts held in net positions.[55] These contracts can be disposed of separately.[56] A straddler may wish to maintain a straddle position in a particular commodity, but have one of his positions in a near delivery month replaced by a similar position in a more distant month. He can do this by closing the near position and simultaneously establishing a new position in a more distant month. This process, called "rolling" or "switching" the straddle, is the essential element of the tax-motivated straddle.

The motives of the tax straddler differ from those of other straddlers.[57] A bona fide straddle speculator seeks to profit from the change

52. R. Gray, *supra* note 25, at 20.

53. In simple straddles the trader will gain or lose when the interest rates change, assuming commodity prices remain constant. For example, the holder of a short silver straddle (a bear straddle) will profit if interest rates decrease. The price of a short straddle is based on the cost of borrowing money to purchase silver during the delivery month of the straddle's earlier long position and to hold the silver until delivery fulfills the obligation of the straddle's later short position. Because the interest rate decreased after the straddler entered the market, his position is more valuable because he can perform his obligations at a lower cost than the one reflected in the costs of his contracts. The corresponding bull or long straddle has decreased in value because its holder is obligated to pay more when he accepts delivery for his later long position than it will cost the clearinghouse to purchase the silver from him during the earlier month, hold it until the later month, and then redeliver it.

Dramatic increases or decreases in commodity prices will also affect borrowing costs and, therefore, the differential. For example, when the price of a commodity increases, the total borrowing cost increases even if the interest rate remains constant.

Butterfly straddles, by coupling a long straddle with a short straddle, eliminate most of the risk of interest rate changes by putting the holder in the position of both profiting and losing from any change in the differential. If the trader holds a perfect butterfly, one with the same number of months between each wing and the body, all the risk from interest rate changes is eliminated. *See* D. Breeden, *supra* note 26, at 1-3; R. Gray, *supra* note 25, at 18-20.

54. Powers, *supra* note 34, at 41-42.

55. The margin deposit required for establishing a straddle is, however, significantly less than the deposit required for a comparable number of net positions. See text accompanying notes 24-26 *supra*.

56. See text accompanying notes 17-20 *supra*.

57. The form of the tax-motivated straddle is identical, however, to that of any other straddle.

in price differential between straddle months. The tax straddler does not seek to profit from changes in the differential; indeed, he prefers not to risk the loss that may result from a change in the differential. The tax straddler secures his straddle in an attempt to postpone and reduce a tax liability stemming from a prior capital gain. To accomplish this goal for the current tax year, the tax straddler purchases a large enough number of straddles so that the normal movement in the price of the commodity underlying his offsetting futures positions will create a nominal loss in one leg of the straddle approximately equal to his prior unrelated gain.[58] The straddler can then "lift" the loss leg of the straddle by closing the contracts that constitute that leg and realize what is usually a short-term capital loss. This loss offsets the unrelated gain, reducing or eliminating the straddler's current tax liability from the unrelated gain.[59]

The tax straddler immediately establishes another position in a different month to protect his unrealized gain in the other leg of the straddle from future price changes and maintains this position into the next taxable year.[60] If successful, the tax-motivated trader can take advantage of the greatly reduced risks per contract that straddle traders enjoy. At the same time he receives tax benefits in the form of capital-loss deductions on his nominal losses equal to those available to the net-position trader. The net-position trader suffers a real economic loss when he closes a losing position, whereas the straddle trader has an unrealized gain that offsets his loss. Although this gain is unrealized, it is, as part of a new straddle, at least partially protected from erosion resulting from subsequent commodity price changes.

The process can be illustrated by an example of a simple tax straddle discussed by the IRS in Revenue Ruling 77-185.[61] In November the investor, who has a large short-term capital gain from a real estate transaction, purchases long silver contracts for delivery next March and short silver contracts for delivery next July. In December the price of silver falls. The investor closes out his long March position by selling

58. Thus, tax straddles are arranged in markets in which price differentials between months are predictable even though the price of the commodity fluctuates.

59. The IRS has disallowed such losses. See text accompanying notes 75-81 *infra*. In Smith v. Commissioner, [Regular Decisions] TAX CT. REP. (CCH) No. 38,835 [78 T.C. No. 26, March 5, 1982), the Tax Court upheld the IRS's disallowance, but, if the straddler can demonstrate profit motive, his case arguably would be distinguishable from the holding in *Smith*. See notes 125-36 *infra* and accompanying text.

60. Statement of Jerome Kurtz, Commissioner, IRS, *reprinted in Silver Prices*, *supra* note 2, at 365-66; *Futures Shock*, *supra* note 13, at 25; Knight & Rowe, *Silver Butterfly 'The Best Little Tax Dodge in America': How It Works*, Wash. Post, Dec. 21, 1980, at G1, col. 1.

61. 1977-1 C.B. 48.

short an equal number of March contracts, thereby realizing a short-term capital loss. The loss is approximately equal to his real estate gain. He immediately reestablishes a straddle by purchasing long September silver; this purchase protects his unrealized gain in short July silver. Thus, if the price rises, the gains on his long September contracts will offset his short July-contract losses. The next year the investor closes out both straddle positions, realizing a short-term gain equal to the previous year's loss, and, in effect, deferring his original short-term gain on real estate for one tax year. This deferral can be repeated each year for as long as desired.

If the price of silver had risen in December, the investor would have switched his short July silver for, possibly, short September silver. He then would realize the loss on his short position and carry the offsetting gain into the next year in the long position. If he keeps the straddle open for at least six months[62] and realizes the gain on the long contract, he may claim long-term capital gain treatment.[63] He thereby succeeds in deferring a short-term gain taxable at a maximum of seventy percent[64] into the next taxable year and converting it into a long-term capital gain taxable at a maximum of twenty-eight percent.[65]

When the contracts which make up straddles are bought or sold simultaneously, traders' bids and offers are proposed spread differentials, not commodity prices.[66] Prices on the individual long and short

62. To keep the straddle open for over six months, he can switch his short March position for one in a later month. In 1977 the Commodity Exchange, Inc. (COMEX), the principal exchange for silver straddle trading, increased the span of contract months for silver futures contracts from 17 to 23. This action made it easier for silver straddle traders to maneuver. *See Stalled Straddle: IRS Ruling on Silver Puts 'Butterfly Spread' Tax Shelter in Question*, Wall St. J., June 6, 1978, at 1, col. 6 (hereinafter cited as *Stalled Straddle*).

63. Gain or loss realized by the holder of a short position in commodity futures is treated as a short-term capital gain or loss regardless of how long the position is held. I.R.C. § 1234(b). Thus conversion of short-term capital gains into long-term capital gains can be accomplished only when the straddle is closed with the gain in the long position.

64. Short-term capital gains do not qualify for the 60% exclusion provided net capital gains. *See* I.R.C. § 1202. Net capital gain is the excess of net long-term capital gain over net short-term capital loss. I.R.C. § 1222. Because short-term gains are not eligible for the 60% exclusion, they were subject to a maximum tax of 70% under the tax tables in effect through December 31, 1981. Revenue Act of 1978, § 101, 92 Stat. 2767 (1978) (current version at I.R.C. § 1). The maximum tax is now 50%. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172.

65. Through June 9, 1981, the maximum tax on long-term capital gains was 28%—the 70% maximum tax imposed on the 40% of the net capital gain remaining after the 60% exclusion. See note 64 *supra*. The maximum tax is now 50%. This change results in a new maximum tax on long-term capital gains of 20%. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 102a, 95 Stat. 172.

66. STAFF OF THE JOINT COMMITTEE ON TAXATION, 97TH CONG. 1ST SESS., BACKGROUND ON COMMODITY TAX STRADDLES AND EXPLANATION OF H.R. 1293, 11 (Comm. Print 1981) (hereinafter cited as BACKGROUND ON TAX STRADDLES); *Stalled Straddle, supra* note 62.

positions comprising the contract are irrelevant[67] and are not established by competitive bidding, but are agreed upon by the two traders involved at a later time and outside the trading pit.[68] Exchange rules allow the traders to assign any price actually traded that day to one leg of the straddle and any price within the exchange's daily price limits—the maximum daily movement in the price of the commodity allowed by the exchange—to the other.[69] The only further restriction in the traders' freedom to choose the prices of these positions is the requirement that the two prices assigned reflect the exact price differential on which the traders agreed.[70]

This flexibility is of no importance to the normal straddle investor, but offers a great advantage to the tax straddler. The tax straddler in an active market can pick very high contract prices for some of his straddles and low prices for others, often achieving the desired "loss" and offsetting "gain" instantly.[71] Until recently, the Commodity Exchange Incorporated (COMEX) made tax straddling even more convenient by providing for after-hours trading sessions exclusively for silver straddles.[72] In these sessions prices could be set in the same manner as for straddles traded during the regular session, but the differential, instead of fluctuating as it does during regular trading hours, remains closely tied to the differential reflected in the closing or settlement price of the session.[73] Thus in the after-hour sessions the tax straddler had the entire day's commodity prices from which to choose without the risk of any undesirable differential fluctuations occurring during the course of his trading.

67. See note 44 *supra*.

68. BACKGROUND ON TAX STRADDLES, *supra* note 66, at 11.

69. *Id.*, *Stalled Straddle, supra* note 62.

70. BACKGROUND ON TAX STRADDLES, *supra* note 66, at 11.

71. The taxpayers in Smith v. Commissioner used this method of "price fixing" to establish instant losses in their straddle transactions. [Regular Decisions] TAX CT. REP. (CCH) No. 38, 835 at 2861-62 (78 T.C. No. 26, March 5, 1982).

72. Rule 502, silver rule 1(b) provided after-hours sessions for silver straddles; gold rule 1(b) provided such sessions for gold straddles. 45 Fed. Reg. 43,820 (1980). Although the gold and silver rules provide for such sessions to be called ouly under "extraordinary circumstances," *id.* at 43,820 n.1, silver sessions were routinely conducted by COMEX on a daily basis. 46 Fed. Reg. 23,516, 23,521 & n.57. Gold sessions, which are also authorized under exchange rules, have not been held. *Id.* at 23,516. On April 27, 1981 the CFTC disapproved the two rules governing after-hour straddle sessions and required all straddle trading to be couducted during regular trading hours. *Id.* at 23,516. The CFTC's reasons for disapproval focused on the competitive effects of such a rule; the tax aspects were not considered. *See* 46 Fed. Reg. 23,516, 23,516-23 (1981), 45 Fed. Reg. 43,820, 43,820-24 (1980). COMEX has challenged the CFTC's action in court. *See Comex Is Suing on Ban to One Session*, Wall St. J., June 17, 1981, at 46 col. 5.

73. 45 Fed. Reg. 43,820, 43,821-22 (1980).

The tax straddler uses the futures straddle to defer tax liability from unrelated income by creating nominal losses on futures contracts to offset the unrelated gains. The losses are nominal because the straddler is almost entirely insulated from actual loss in the futures market by the presence of offsetting positions. Additionally, if the unrelated capital gain is short-term, the straddle can be used to convert it into long-term gain by providing a holding period in which the gain is subject to little risk.[74] Fluctuations in the differential and resulting changes in the margin requirements do create some risk for the straddle trader, but that risk is minimal. The straddle insulates the trader from the risk of commodity price changes even though those price changes are the means by which the trader realizes a nominal loss when he rolls his straddle.

III. Analysis of Tax Straddles: Revenue Ruling 77-185 and *Smith v. Commissioner*

In Revenue Ruling 77-185[75] the IRS disallowed losses claimed in a tax-straddle transaction and presented two separate tax theories to justify this decision.[76] First, the ruling relies on a "closed-transaction" theory derived from Treasury Regulation 1.165-1(b).[77] According to this theory, the taxpayer establishes a balanced position with his initial long and short contract purchases and remains in a balanced position after the close of one long or short position because of his immediate purchase of another long or short position.[78] Because the straddler continues to hold balanced positions, the IRS argues that the transaction is not complete and that any deduction of losses is therefore premature.[79] Second, the IRS claims that tax straddlers lack a profit

74. *See* Cooper, *The Avoidance Dynamic: A Tale of Tax Planning, Tax Ethics, and Tax Reform*, 80 COLUM. L. REV. 1553, 1566-70 (1980).

75. 1977-1 C.B. 48. The facts of Revenue Ruling 77-185 are a simplified version of the transactions of two Merrill Lynch, Pierce, Fenner & Smith customers, Harry L. Smith and Herbert J. Jacobson, the petitioners in Smith v. Commissioner, [Regular Decisions] TAX CT. REP. (CCH) No. 38,835, at 2851 (78 T.C. No. 26, March 5, 1982). *See Futures Shock*, *supra* note 13, at 25. Smith and Jacobson actually used a butterfly straddle but the revenue ruling hypothetical uses a simple straddle. The claimed tax advantages that are the subject of the ruling are identical to those resulting from butterfly straddles. The relevant differences between the two straddles are that the butterfly straddler must buy and sell twice as many contracts when switching months and that there is less risk of actual loss in a butterfly straddle than in a simple straddle. See text accompanying notes 49-53 *supra*.

76. 1977-1 C.B. 48. The ruling also disallowed deductions for out-of-pocket expenses. Such deductions are allowed when the expenses are incurred in profit-motivated transactions. *See* I.R.C. § 165(c).

77. T.D. 6735, 1964-1 C.B. 100, 101.

78. 1977-1 C.B. 48, 50.

79. See text accompanying notes 74-75 *infra*.

motive in trading straddles.[80] The IRS relies on section 165 of the Internal Revenue Code, which requires that only losses incurred in a "transaction entered into for profit" may be claimed to offset tax liability.[81]

In *Smith v. Commissioner* the Tax Court denied the taxpayers' claimed straddle losses, finding that the particular straddle transactions employed, when considered as a whole, lacked the requisite profit motive.[82] In analyzing the straddle, the *Smith* court rejected four alternative rationales for its holding: the closed-transaction analysis of Revenue Ruling 77-185;[83] a wash-sale analysis, closely related to the closed-transaction analysis but not based on I.R.C. section 165;[84] a unit approach which regards a straddle as a single unit rather than two separate contracts;[85] and the step-transaction analysis which combines formally independent but substantively interdependent steps into a single extended transaction for the purpose of determining tax consequences.[86]

A. *Profit Motive.*

Section 165(c) of the I.R.C. limits an individual's claim for a loss deduction from a transaction occurring outside the scope of a trade or business to losses incurred in transactions entered into for profit.[87] The IRS must determine profit motive on a case-by-case basis, by scrutinizing the substance of the transaction as well as the subjective belief of the taxpayer.[88] To find a profit motive, a "moral certainty that profit will result" is not necessary; mere hope of monetary gain is sufficient.[89] Transactions entered into for profit include transactions undertaken in the hope of avoiding loss, but not transactions in which "the transac-

80. 1977-1 C.B. 48, 50.
81. See text accompanying notes 87-90 *infra*.
82. Smith v. Commissioner, [Regular Decisions] TAX CT. REP. (CCH) No. 38,835, at 2871-73 (78 T.C. No. 26, March 5, 1982).
83. *Id.* at 2866.
84. *Id.* at 2873.
85. *Id.* at 2874-76.
86. *Id.* at 2866-67.
87. I.R.C. § 165(c)(2).
88. *See* Weir v. Commissioner, 109 F.2d 996, 997-98 (3d Cir.), *cert. denied*, 310 U.S. 637 (1940); Bessenyey v. Commissioner, 45 T.C. 261, 274 (1965); Sabelis v. Commissioner, 37 T.C. 1058, 1062-63 (1962); Ewing v. Commissioner, 20 T.C. 216, 233 (1953); Worcester Bank & Trust Co. v. Commissioner, 13 B.T.A. 630, 632-33 (1928); *cf.* Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963) (applying dicta from Welch v. Helvering, 290 U.S. 111, 116 (1953), to profit-motive qnestions: "Many cases in the federal courts deal with phases of the problem in the case at bar. To attempt to harmonize them would be a futile task. They involve the apprcciation of particular situations, at times with borderline conclusions").
89. Fox v. Commissioner, 190 F.2d 101, 104 (2d Cir. 1951).

tion is clearly a losing one, . . . as where under all the circumstances known to the taxpayer at the time it is a hopeless venture."[90]

In Revenue Ruling 77-185 the IRS relied on *Knetsch v. United States*[91] and *Brown v. United States*[92] in disallowing the short-term capital loss and the out-of-pocket expenses deducted by the taxpayer. *Knetsch* involved a scheme in which the taxpayer borrowed money from an insurance company to pay for a deferred annuity bond purchased from the same company. Using the annuity bond as security, he then borrowed additional sums from the insurance company to pay the interest on the annuity-bond loan. Because income from the annuity bond was not taxable until received and interest was deductible when paid, the taxpayer had a substantial nominal loss which he sought to use to offset other income.[93]

The IRS disallowed Knetsch's interest deduction, claimed under section 163(a) of the I.R.C., and the disallowance was upheld by the Supreme Court.[94] In a later year Knetsch abandoned the annuity scheme and claimed out-of-pocket loss deductions for the excess of the interest and cash he paid to the insurance company over the "loans" and cash value remitted to him upon termination of the annuity.[95] Knetsch justified the deductions as losses incurred in a transaction entered for profit under section 165(c)(2) of the I.R.C. or, alternatively, as expenses paid for management, conservation or maintenance of income under section 212(2).[96]

The Court of Claims agreed that the taxpayer had suffered a loss within the meaning of section 165 of the I.R.C., but held that the taxpayer had failed to meet the requirement of section 165(c) that the loss be incurred in "transactions entered for profit."[97] The court also held that profit motive was required in order for the taxpayer to claim out-of-pocket expenses under section 212(2) of the I.R.C.[98] The court concluded that the taxpayer did not intend to use the annuity for its potential profit features, but rather that the taxpayer's " 'annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000.' "[99]

---

90. *Id.*
91. 348 F.2d 932 (Ct. Cl. 1965).
92. 396 F.2d 459 (Ct. Cl. 1968).
93. 348 F.2d at 934.
94. Knetsch v. United States, 364 U.S. 361, 362, 367-70 (1960).
95. Knetsch v. United States, 348 F.2d 932, 934 (Ct. Cl. 1965).
96. *Id.* at 935.
97. *Id.* at 936.
98. *Id.* at 939.
99. *Id.* at 939 (quoting Knetsch v. United States, 361 U.S. 361, 366 (1960)).

The *Knetsch* court also considered the possibility of mixed motives in a transaction, observing that although a motive to effect a tax reduction cannot produce a transaction entered into for profit in the statutory sense, "a prohibited profit motive or intent" such as tax avoidance, can exist "side by side with a legitimate profit motive or intent and meet the statutory requirement."[100] The *Knetsch* court did not, however, reach the question whether a dominant tax-avoidance motive causes disallowance of an interest deduction despite the presence of a secondary permissible profit motive. Dicta from the case indicates that the deduction would be allowed.[101]

In *Brown* the taxpayer realized that under the *Knetsch* rule he could not deduct interest from a transaction not entered into for profit, so he sought to claim pre-paid interest as an expense and deduct it as a capital loss under section 212 of the I.R.C.[102] In disallowing the capital-loss deduction, the court again conceded the reality of the loss and stressed that the recognition of a capital loss is not sufficient to establish its deductibility; the loss still must meet the profit-motive requirements of section 165(c).[103]

Together, the two *Knetsch* cases and the *Brown* case stand for the principle that losses, interest payments, and out-of-pocket expenses incurred in transactions entered into with no profit motive are not deductible under sections 163, 165 or 212 of the I.R.C. The problem of mixed-motive transactions is the major difficulty the courts will face in applying the profit-motive test to tax-straddle transactions. The courts must determine which standard to apply under section 165 to straddle-trading transactions in which the tax-avoidance motive dominates a weak but existing profit motive.

An analysis of the profit-motive cases indicates that if the taxpayer can show a subjective intent to profit from the straddle, and prove

100. *Id.* at 936.

101. The word purpose carries with it not only taxpayer's intent, but also his motive for entering the transaction. Thus, you can have a profit intention side-by-side with a non-profit motive. However, the statutory requirement "for profit" can be satisfied by either. By the same token, you can have a prohibited profit motive or intent and meet the statutory requirement.

Id. at 936.

The court added:

> We think that the reasoning in Goodstein [that expenses although incurred in connection with transactions which had been entered into solely for the purpose of avoiding tax, are deductible if the expenditure gives rise to a contractual obligation, which if carried out would give rise to a profit or a loss] is correct if the reviewing court is not faced with the factual determination that the contractual obligation was *not* itself a sham.

Id. at 938 (emphasis in original).

102. 396 F.2d at 463.

103. *Id.* at 465-66.

profit potential in his straddle transactions, he will probably withstand any profit-motive attack on his deductions despite the presence of a strong tax-avoidance motive. Judicial standards that ignore the presence of a significant, bona fide profit motive in certain instances do not reach the tax-straddle situation.

1. *Primary or dominant-motivation test.* The primary-motivation test used by the Supreme Court in *Helvering v. National Grocery Co.*[104] indicates that obtaining a loss deduction under the predecessor to I.R.C. section 165(c)(2) "may depend on whether the taxpayer's motive in entering the transaction was primarily profit."[105] Courts have applied the primary profit-motive test in situations in which taxpayers claim deductions for losses in transactions supposedly entered into for profit[106] or for expenses alleged to have a business purpose.[107] The legitimate profit motive in these cases is combined with other motives such as personal pleasure or generosity that, standing alone, do not support a deduction.[108] The primary-motivation test has not been applied, however, to situations in which a tax-avoidance motive is joined with the profit motive or business purpose.

2. *Significant-motivation test.* Under the significant-motivation test, the deduction of a loss is disallowed when there is proof of a substantial tax-avoidance purpose despite the presence of even a dominant legitimate purpose. Courts have applied this more stringent standard only when a statute either specifies its application or implies such by its intent to prohibit a particular form of tax avoidance. A version of the test was employed under federal estate tax provisions of section 2035 of the I.R.C.,[109] which created the rebuttable presumption that transfers made within two years of death were made in contemplation of

104. 304 U.S. 282 (1938).

105. *Id.* at 289 n.5. *But see* Weir v. Commissioner, 109 F.2d 996 (3d Cir.), *cert. denied*, 310 U.S. 637 (1940) (indicating that any bona fide profit motive is sufficient to allow a loss and it does not have to be the primary motive).

106. I.R.C. § 165.

107. I.R.C. § 162.

108. *See, e.g.*, Lamont v. Commissioner, 339 F.2d 377, 380 n.4 (2d Cir. 1964); Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963); Austin v. Commissioner, 298 F.2d 583, 584 (2d Cir. 1962); Arata v. Commissioner, 277 F.2d 576, 578 (2d Cir. 1960); Meuer v. Commissioner, 221 F.2d 223, 224 (2d Cir. 1955); Ewing v. Commissioner, 213 F.2d 438, 439 (2d Cir. 1954); Feine v. McGowan, 188 F.2d 738, 740 (2d Cir. 1951); Gevirtz v. Commissioner, 123 F.2d 707, 708 (2d Cir. 1941); Jasionowski v. Commissioner, 66 T.C. 312, 319 (1976).

109. Internal Revenue Code of 1954, § 2035(a), Pub. L. No. 68-591, 68A Stat. 381 (re-enacting Revenue Act of 1918, § 402(c), 40 Stat. 1057, 1097)).

death.[110] Another version of the test is used under the accumulated-earnings provisions of sections 531-537 of the I.R.C.[111] The statutory language and legislative history of the accumulated-earnings provisions direct the use of the substantial-purpose test.[112] There is no equivalent legislative intent to guide the courts in determining which standard to apply in section 165(c) profit-motive determinations.[113]

---

110. *See* United States v. Wells, 283 U.S. 102, 115, 118 (1930) (construing Revenue Act of 1918, § 402(c), 40 Stat. 1057, 1097). Although the decision can be read as invoking a dominant-purpose test rather than a significant-purpose test, a close reading reveals that a clear showing of a testamentary purpose as a significant motive for the transfer creates tax liability under *Wells*. A contrary motive, even if dominant, will defeat the statutory presumption that transfers to the transferor's beneficiaries within two years of his death (3 years in later versions) are made in contemplation of death only where there is no showing that contemplation of death is a motive at all. *See* 283 U.S. at 115-18. The "contemplation of death" language was carried over into the Internal Revenue Code of 1954 at section 2035, Pub. L. No. 68-591, 68A Stat. 381. Section 2035 was amended by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525, 1848. The new provision eliminated the "contemplation of death" presumption and substituted an objective test that, with a few specific exceptions, requires that all transfers made within three years of death regardless of motive be included within the estate for estate tax purposes. I.R.C. § 2035(a). As the legislative history reveals, the motive question inherent in the "contemplation of death" language of the previous statute was the major reason for the new provision:

> The presumption that gifts made within three years of death are in contemplation of death has caused considerable litigation concerning the motives of decedents in making gifts. Your committee believes that this problem should be eliminated by requiring the inclusion of all such gifts in the gross estate without having to attempt to ascertain the motives of the decedent.

H. REP. No. 1380, 94th Cong., 2d Sess. 12, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3366.

111. United States v. Donruss Co., 393 U.S. 297 (1969). The Court stated:

> The Government contends that in order to rebut the presumption in § 533(a) [unreasonable accumulation of earnings and profits is presumed determinative of the purpose to avoid income tax], the taxpayer must establish by the preponderance of the evidence that tax avoidance . . . was not "one of the purposes" for the accumulation . . . .
>
> We conclude from an examination of the language, the purpose, and the legislative history of the statute that the Government's construction is the correct one.

Id. at 301. The report of the Senate Finance Committee, quoted in *Donruss*, discussed the rationale for the stringent rule in section 533: "The proposal is to strengthen [the evidentiary] section by requiring the taxpayer by a clear preponderance of the evidence to prove the absence of *any* purpose to avoid surtaxes upon shareholders." *Id.* at 303 (quoting S. REP. No. 1567, 75th Cong., 3d Sess. 5 (1938)) (emphasis in original).

112. *See* United States v. Donruss Co., 393 U.S. 297, 303-08 (1969); United States v. Wells, 283 U.S. 102, 115-18 (1930).

113. Section 531 was intended to address a particular tax-avoidance problem, and the strong significant-motivation test is justified by the specificity of the statute's purpose. See note 119 *supra*. Congress did not design section 165 to focus specifically on tax-avoidance motives. To the contrary, the provision which is now I.R.C. section 165(c) was originally introduced to expand the categories of transactions in which losses could be claimed to include transactions entered for profit. Revenue Act of 1918, 40 Stat. 1057. Previously such losses could not be deducted unless sustained in transactions involved in a business or trade. H.R. REP. No. 767, 65th Cong. 2d Sess. (1918). Although the provision has been added to and rearranged since its enactment, its substance remains the same.

Like section 165(c), but unlike section 531, the language and legislative history of section 2035 prior to 1976 did not suggest the application of any particular standard for measuring mixed taxpayer motives. Acting without legislative guidance, the courts measured taxpayer intent under a dominant-purpose test unless the competing motive was tax avoidance. When tax avoidance was the competing motive the courts used a significant-motive standard.[114] Despite the rough similarity of the section 2035 tax-avoidance situation to that of the tax straddle, there are compelling reasons not to extend the significant-motive standard to more general areas in which tax-motivated behavior is observed. First, Congress has abandoned the contemplation-of-death motive inquiry for section 2035 primarily because of difficulties in its application.[115] Under section 165(c), the inquiry into motive is even more difficult because of the greater variety of situations that are encompassed by that section. Second, application of a judge-made significant-purpose test would defeat congressional intent in many instances. Congress uses tax benefits to encourage certain taxpayer behavior and intends tax avoidance to be a significant motivation for that behavior. Under the significant-motive test, a court disallows a deduction when the taxpayer is motivated by tax avoidance even if his primary goal is to make a profit in a manner consistent with Congress's policy objective.[116] Finally, in cases in which the statute does not dictate or imply the appropriate standard, courts have held that any bona fide transaction, unless trivial, produces deductible losses even if the dominant motive is to reduce taxes.[117]

The profit-motive cases cited in Revenue Ruling 77-185 involve sham transactions in which the courts held that no significant profit motives existed.[118] Courts have recognized that the presence of a tax-avoidance motive will not destroy the validity of an otherwise legitimate transaction without demonstrated, contrary congressional intent. Thus the courts have never applied the primary-motivation test to

114. *See* United States v. Wells, 283 U.S. 102, 117 (1930); Farmers' Loan & Trust Co. v. Bowers, 98 F.2d 794, 798-99 (2d Cir. 1938).

115. See note 110 *supra*.

116. As the Court of Appeals for the Third Circuit observed: "If tax avoidance, within the rules, is to take a case out of a deduction provided by statute, we think every legally advised taxpayer is going to find himself in very hot water." Evans v. Dudley, 295 F.2d 713, 715 (3d Cir. 1961).

117. In United States v. Consumer Life Ins. Co., 430 U.S. 725 (1977), the Court stated, "Tax considerations may well have had a good deal to do with the specific terms of the treaties, but even a 'major motive' to reduce taxes will not vitiate an otherwise substantial transaction." *Id.* at 739. *See* Wiggin v. Commissioner, 46 F.2d 743, 745-46 (1st Cir. 1931); Terry v. United States, 10 F. Supp. 183, 185 (D. Conn. 1934); Starr v. Commissioner, 46 T.C. 450, 460 (1966).

118. See notes 96-113 *supra*, and accompanying text.

mixed motive cases where tax avoidance competes with the legitimate motive and have applied the significant-motivation test in such cases only when Congress has specifically required such a standard.

3. *The Tax Court's profit-motive analsysis*. The Tax Court was able to avoid mixed-motive analysis in *Smith v. Commissioner*,[119] the first court test of Revenue Ruling 77-185. *Smith* involved the prototypical tax-straddle transaction where taxpayers, seeking to shelter large gains obtained in transactions unrelated to straddle investments, turn to the tax straddle. The Smiths and the Jacobsons employed the Tax Straddle Department of Merrill, Lynch, Pierce, Fenner and Smith (Merrill Lynch) for this purpose.[120] The IRS disallowed their claimed losses resulting from commodity straddle trades, and they appealed to the Tax Court. The Tax Court held that their losses were not incurred in transactions entered for profit and therefore were not deductible.[121]

The Tax Court looked both at the subjective intent of the taxpayers and at the objective nature of the tax-straddle transaction. The taxpayers had no independent knowledge of the profit potential of straddles and relied upon the descriptions of the straddle transactions and the projections of possible outcomes provided by representatives of Merrill Lynch.[122] Merrill Lynch's representatives stressed the tax benefits of the transactions and the possibility of econonric loss inherent in the transactions but cstimated that the best possible outcome from the straddle, tax considerations aside, would leave each taxpayer $1,000 poorer.[123] Thus the court concluded that neither the taxpayers nor Merrill Lynch subjectively viewed the overall tax-straddle scheme as offering the possibility of economic profit.[124]

The court's analysis of the inherent economic substance and profitability of the straddle was limited to tax straddles, while the IRS attempted to encompass all straddles.[125] The IRS argued that straddles in general lacked economic substance[126] and that if straddles were held to have substance, then a proper accounting of losses for tax purposes would require an integration of the various steps of the straddle into a

119. [Regular Decisions] TAX CT. REP. (CCH) No. 38,835 (78 T.C. No. 26, March 5, 1982).

120. *Id.* at 2851-82.

121. *Id.* at 2876.

122. *Id.* at 2875.

123. *Id.*

124. *Id.* at 2874-76.

125. For the IRS position see notes 87-118 *supra* and accompanying text. For the court's position see notes 119-124 *supra* and accompanying text.

126. *See* Smith v. Commissioner, [Regular Decisions] TAX CT. REP. (CCH) No. 38,835 at 2862 (78 T.C. No. 26, March 5, 1982).

single transaction under either the closed-transaction analysis[127] or the step-transaction doctrine.[128] The court upheld the validity of the straddle against this substance attack[129] and ruled that the various positions obtained were separate and should not be integrated for tax purposes.[130]

Despite the court's ruling on the form and substance of the straddle, the court departed from this general view in its examination of the profit motive inherent in a tax straddle as opposed to a simple straddle. The court's profit-motive analysis of the tax straddle appears to be a step-transaction analysis limited to the purpose of determining profit motive. The court found the commodity tax straddle to be a "prearranged, planned sequence of trading" calculated to achieve certain tax benefits, as opposed to "simple investments in butterfly straddles held solely for non-tax profit objectives."[131] Thus, according to the court, the proper unit to examine for profit motive is "the entire tax straddle scheme," which it determined to be a single "transaction"[132] for the purposes of I.R.C. section 165(c)(2).[133]

Viewed prospectively, the court's holding is encouraging to many tax straddlers, especially those whose contested returns were filed after the publication of Revenue Ruling 77-185, because it suggests that tax straddle losses will be upheld where the investor designs his straddle transactions in such a way as to create the possibility of economic gain from the overall transaction.[134] The straddle transaction can yield tax savings that are greatly disproportionate to its non-tax economic potential.[135] In future tax straddle cases if the taxpayer is able to show that he was aware of and, in part, motivated by the profit potential of his tax straddle, the mixed-motive analysis might prove inevitable. The *Smith* court's dicta, following the precedent in profit-motive cases, indicates that the losses claimed in such a mixed-motive transaction would be

127. *Id.* This is the closed-transaction argument or wash-sale rule. *See* 1977-1 C.B. 48, 50. See notes 159-81 *infra* and accompanying text. The Tax Court dealt with the closed-transaction argument separately from the wash-sale analysis but refused to apply either. *See* [Regular Decisions] TAX CT. REP. (CCH) at 2863-67.

128. *See id.* at 2862.

129. *Id.* at 2850, 2863-66.

130. *Id.* at 2850, 2866-67.

131. *Id.* at 2874.

132. *Id.*

133. This approach mooted the taxpayers' arguments for the validity of straddle transactions in general. It also mooted any argument which a tax straddler might make concerning the substance of a single-component transaction of his tax-straddle scheme, although the court felt that it would have reached the same conclusion if it had examined the transactions individually. *See id.* at 2881 n.30.

134. See notes 120 *infra*.

135. See notes 54-65 *supra* and accompanying text.

allowed.[136]

The IRS may be able to avoid the mixed-motive analysis even where the taxpayer can make such a showing by focusing its profit motive requirement on the single transaction that is critical for the tax-motivated trader but seldom used by the legitimate straddle trader. That transaction is the rolling of the straddle's loss leg that is executed before the close of the taxable year to generate losses.[137] Although the switch has substance and does not leave the trader in the same position,[138] it may often leave the trader in a worse position. Thus the taxpayer may find it difficult to show that he reasonably expected to profit from his new position.[139]

4. *Double taxation caused by the profit-motive analysis.* A finding of liability in a tax straddle case based on the profit-motive analysis creates a harsh result. When a tax straddler loses his claimed deduction for straddle losses in the first year of a tax straddle because the court finds no profit motive in the transaction, he is taxed on the full amount of the gain he was attempting to shelter. Then, in the next year, he is taxed on the "gain" realized by closing out his tax straddle. This artificial "gain" bears as little resemblance to the taxpayer's economic position as did the straddle loss. Nevertheless, double taxation is an inevitable result of the application of the profit-motive analysis to the tax straddle transaction.

Although the Tax Court's holding in *Smith* was based on a profit-motive analysis and resulted in double taxation, the court's recalculation of the taxpayers' straddle losses and gains had the effect of mitigating the harshness of the result in that particular case.[140] Because the straddles in *Smith* were traded in the after-hours straddle call session,[141] the court viewed any prices assigned to the contracts other than the closing or settlement prices as artificial.[142] Although the exchange's rules allow the assignment to straddle leg contracts of virtually any

136. *See* [Regular Decisions] TAX CT. REP. (CCH) at 2874. See note 17 *supra* and accompanying text.

137. See text accompanying notes 54-60 *supra*.

138. See note 160 *infra* and accompanying text.

139. To prove a reasonable expectation of profit, the taxpayer must provide some evidence of a change in the market from which he seeks to profit by altering his straddle position. *See* Ginsberg & Seidel, *supra* note 35, at 2-3, 37-41; Levy, *supra* note 129, at 479.

140. *See* Smith v. Commissioner, [Regular Decisions] TAX CT. REP. (CCH) No. 38,835, 2867-71, 2879 nn.24-25 (78 T.C. No. 26, March 5, 1982).

141. See notes 66-73 *supra* and accompanying text.

142. *See* [Regular Decisions] TAX CT. REP. (CCH) at 2867-68.

prices occurring within the day's trading limits to the straddle legs,[143] the court, characterizing the straddle transaction as an "exchange of contracts,"[144] felt free to ignore the prices set by the parties to the exchange and to assign fair market value to the positions.[145] The court found the fair market value to be the day's settlement price and recalculated the straddle transactions on that basis.[146]

COMEX was the only exchange to use an after-hours session,[147] and the COMEX session involved only silver straddles.[148] As a consequence the court's recalculation method cannot properly apply to straddle transactions executed on other exchanges or in other commodities. The *Smith* court did not mention how it would determine prices for contracts executed during regular trading hours where reference to the settlement price would be as artificial as relying on the prices allowed under the exchange's rules. Presumably any court trying to determine the actual price of contracts comprising the straddle would confront the same problem that convinced the *Smith* court to reject the unit approach: the practical difficulty of having to determine the price at which open positions were trading on the exchange floor at the instant the straddle trade was executed.[149]

A tax straddler who generates nominal straddle losses by actual rises or falls of the price of the commodity in the market may have his entire straddle loss deduction upheld by a court following *Smith* provided he meets the profit-motive burden. If he fails to meet this burden he will be taxed twice.

B. *The Unit Approach.*

As mentioned above, the true measure of the straddle's economic substance is the differential between the contracts comprising each leg.[150] The unit approach discussed in *Smith* would require the tax consequences of straddle trading to be based on this differential rather than the actual prices of the straddle's component futures contracts.[151]

143. *Id.* at 2861-62; BACKGROUND ON TAX STRADDLES *supra* note 66, at 11; *Stalled Straddle, supra* note 62.

144. [Regular Decisions] TAX CT. REP. (CCH) at 2870.

145. *See id.* at 2870, 2879 nn. 24-25.

146. *See id.*

147. 45 Fed. Reg. 43,820, 43,822 n.15 (1980).

148. *Id.* at 43,821 & n.7 (1980).

149. *See* [Regular Decisions] TAX CT. REP. at 2866.

150. Chipser v. Kohlmeyer & Co.; 600 F.2d 1061, 1068 (1979); Smith v. Commissioner, [Regular Decisions] TAX CT. REP. (CCH) No. 38,835, at 2868 (78 T.C. No. 26, March 5, 1982). See notes 41-48 *supra* and accompanying text.

151. *See* [Regular Decisions] TAX CT. REP. at 2866, 2878 n.14.

The unit approach alters the conventional tax treatment of straddles whenever one straddle leg is switched while leaving the other leg of the straddle in place. In this situation the unit approach requires the value of the remaining open position to be offset against the price at which the other leg was closed out in the switching transaction.[152] When both legs of a straddle are bought and sold simultaneously, the tax result under the unit approach will be identical to that of the conventional analysis which treats each futures contract independently. This is true because in simultaneous closing of both legs of a straddle the artificial gains and losses on either leg cancel each other out.[153]

The Tax Court concéded that the unit approach had "much to recommend it from an economic standpoint."[154] Nevertheless the court rejected the approach, suspecting that "problems of proving what the untraded leg's price was at the exact moment of the other leg's trade . . . would be enormous."[155] The court also felt that such an approach would "introduce an element of arbitrariness" into the tax treatment of commodity futures by taxing straddles achieved by simultaneous trades under the unit analysis while otherwise identical straddles achieved by consecutive trades—one leg at a time—would not be so taxed.[156]

Recognition of these problems may be one reason why the IRS did not adopt the unit approach in its treatment of straddles. Nevertheless the closed-transaction approach pursued by the IRS and the step-transaction approach reflect the true economic reality of a straddle transaction by withholding recognition of losses until the remaining straddle positions are closed out and previously unrealized gains are realized and netted against the nominal losses realized earlier.[157] By requiring a taxpayer to report gains and losses in open positions as well as those which are closed out, the Economic Recovery Tax Act of 1981 arrives at the same tax result as would the unit approach, closed-transaction analysis, and the step-transaction analysis.[158]

C. *The Closed-Transaction Analysis and the Wash-Sale Rule.*

The IRS argues in Revenue Ruling 77-185 that the sale of the initial long position of a straddle does not constitute a change in the tax-

152. *Id.* at 2866.
153. See note 39 and accompanying text.
154. *Id.*
155. *Id.*
156. *Id.*
157. See discussion of the closed-transaction analysis at notes 159-81 *infra* and accompanying text. See discussions of the step-transaction doctrine at notes 182-208 *infra* and accompanying text.
158. *Id.* See note 3 *supra*.

payer's economic position.[159] The argument relies on the assumption that the later straddle, which has a long position of the same magnitude as the earlier one but has a different delivery month, is virtually identical to the previous straddle. Accordingly, the "switching" transaction should have no tax consequences because "switching" delivery months is an exercise with no economic substance. The argument concludes that switching leaves the taxpayer in virtually the same ongoing position and that the taxpayer has not "closed and completed" the straddle transaction for loss deduction purposes as required by Treasury Regulation 1.165-1(b).[160]

The two straddles are, however, usually not identical. Often, the nature of the straddle changes when the taxpayer closes out a loss position and establishes a new straddle. He may find himself holding a bear straddle rather than his previous bull straddle. Bear straddles and bull straddles perform oppositely under identical market conditions.[161] A trader who switches from a bull straddle to a bear straddle or vice versa places himself in a different economic position.[162]

The IRS relied on two cases to support the closed-transaction argument: *Frederick R. Horne*[163] and *Gordon MacRae*.[164] Neither of these cases concerns transactions involving commodity futures or similar contracts. The opinions merely contain broad dicta that may lend general support to the ruling's position.

---

159. 1977-1 C.B. 48, 49.

160. *Id.*

161. Bull straddles spread profit when price differentials between the straddle months increase; bear straddles spread profit when price differentials between the straddle months decrease. Schwager, *supra* note 34, at 13-14; see text accompanying notes 39-46 *supra*.

162. If an investor switches a bull straddle for a bear straddle when he changes contract months, spread variations that before would have created gains now create losses and vice versa. Even when switching from one bull straddle to another bull straddle the economic potential of the new position can be substantially different from the old one. Seasonal variations in perishable commodities give various bull or bear spreads very different prospects depending on the delivery months. *See* Powers, *supra* note 34, at 44-45. The inherent risk involved in spread positions whether in perishable commodities or in storable commodities or financial futures is critically dependent on the distance between the legs of the spread; the greater the distance the greater the risk. *See* D. Breeden, *supra* note 53, at 12. General assertions that simple spreads and butterfly spreads are completely without risk or that one spread switched to another with a different delivery month does not at all change the investor's economic position are simply wrong. *See* Schwager, *supra* note 34, at 13-14; Tiger, *supra* note 40, at 15. On the other hand, certain spreads, especially butterfly spreads, held for short periods of time, can be virtually risk-free, or can have such a small risk that profits frequently are completely absorbed by the commission charges. *See* R. Gray, *supra* note 25, at 29, 39-40.

163. 5 T.C. 250 (1945) (a commodity trader sold his seat on the exchange for a price lower than what he paid for it after purchasing an identical seat on the same exchange at the lower price; as he admitted, the sole purpose for the transaction was to claim a loss).

164. 34 T.C. 20 (1960) (purchases and sales of treasury bonds and notes had the effect of cancelling each other out).

The *Horne* court disallowed the taxpayer's deduction derived from a loss claimed on the sale of a seat on the Cotton Exchange and considered instead the completed transaction which included the purchase of an identical seat. The combined sale and purchase left the taxpayer in the same position as before the sale.[165] The *Horne* court relied on *Schoenberg v. Commissioner*,[166] which also involved a transaction that was characterized by a loss claimed on a sale followed by the repurchase of substantially identical property in a manner that precluded any economic risk. In *Gordon MacRae* the taxpayer was involved in a series of transactions consisting of purchases and sales of treasury bonds and notes. The court noted that "[t]he steps taken, each in itself a legitimate commercial operation, were here mirror images . . ., *i.e.*, identical and virtually simultaneous purchases and sales."[167]

Horne, *Schoenberg*, and *MacRae* arguably are irrelevant because the closing of a long (or short) commodity futures position in one month and the virtually simultaneous opening of a long (or short) position in a different month are not identical transactions.[168] The closed-transaction analysis is an attempt to catch all tax-straddle transactions in a single objective net to avoid a case-by-case analysis. It lacks the necessary scope because it cannot apply to the rolling of a straddle whenever the resulting straddle has a different economic potential than the initial straddle.

In Revenue Ruling 77-185 the IRS appears to be trying to create an administrative wash-sale rule[169] in the guise of closed-transaction analysis for futures transactions that are part of ongoing straddles. Although the loss claims stemming from such straddles may be as ficti-

---

165. 5 T.C. at 253-54. "Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense." *Id.* at 254.

166. 77 F.2d 446 (8th Cir.), *aff'g* 30 B.T.A. 659 (1934), *cert. denied*, 296 U.S. 586 (1935) (an attempt to avoid the wash-sale provisions of I.R.C. section 1091 by repurchase through an investment company that the taxpayer controlled). See note 168 *infra*.

167. 34 T.C. at 26-27.

168. In certain markets when conditions are stable, a trader can roll a straddle and remain in the same economic position because the differential costs do not change. The "closed-transaction" analysis may apply to this small number of switches. The "closed-transaction" analysis might apply more frequently when the investor has used butterfly straddles. In those straddles, due to their greater insulation from risk, the potential for profit is often, but not always, outweighed by commission costs. See note 162 *supra*. Butterfly straddles are, however, often profitable in periods of high market variability despite their higher transaction costs, which are caused by the larger number of contract months and switching transactions required. *See generally* D. Breeden, *supra* note 53.

169. A wash sale is a sale and purchase of the same or similar property within a short period of time. I.R.C. section 1091 contains a legislative wash-sale rule for securities. The term "administrative wash sale rule" was used by Barbakoff & Sabin, *supra* note 12, at 5. It suggests an unprecedented attempt by the IRS to expand section 1091 beyond its legislatively defined borders.

tious as those that inspired wash-sale legislation, switches in straddles are not wash sales. Even in the rare case in which the new economic position is nearly identical to the one it replaces and the application of an administrative wash-sale rule may be justified, the IRS is hampered by a body of law that is contrary to the application of such a rule to straddle transactions.

Ironically, straddle traders have used an argument similar to the balanced-position/closed-transaction argument in unsuccessful attempts to avoid tax liability for gains realized in switching delivery months. The straddle traders, hedging against their commodity inventories, sought to postpone the realization of any gains until they closed their futures positions without repurchasing new ones. In those cases, the IRS argued against application of a wash-sale analysis and won.[170] The IRS appears to oppose the application of the closed-transaction doctrine to a switching transaction in which a taxpayer seeks to postpone realization of a straddle gain,[171] but to support the application of the doctrine to force postponement of a taxpayer's loss.[172]

In Revenue Ruling 71-568[173] the IRS took the position that commodity futures contracts are not stocks or securities for purposes of the wash-sale provisions of section 1091 of the Internal Revenue Code. The facts in the ruling involved a speculator who realized a loss on the sale of one futures contract and within thirty days of the sale purchased another contract with a different delivery month. The second contract involved the purchase of the same underlying commodity in equal quantity and quality.[174] The IRS allowed the loss and did not apply an administrative wash-sale rule, which it appears to have used in Revenue Ruling 77-185. This earlier position can be seen as a tacit acknowledgement that, at least absent any offsetting positions, commodity futures contracts for different months are not substantially identical property. When offsetting positions are present, as is the case with straddle transactions, the application of Revenue Ruling 71-568 is less

170. *See* Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33 (6th Cir. 1945), *rev'g* 2 T.C.M. 1172 (Dec. 28, 1943); Corn Prods. Ref. Co. v. Commissioner, 16 T.C. 395 (1951), *aff'd*, 215 F.2d 513 (2d Cir. 1954), *aff'd on other grounds*, 350 U.S. 46 (1955); Harriss v. Commissioner, 44 B.T.A. 999 (1941), *aff'd*, 143 F.2d 279 (2d Cir. 1944); Valley Waste Mills v. Page, 27 A.F.T.R. 957 (M.D. Ga. April 11), *aff'd*, 115 F.2d 466 (5th Cir. 1940), *cert. denied*, 312 U.S. 681 (1941).

171. This requires "switching" a long position, which involves buying a short position in the same month to cancel out the first long position, see text accompanying note 20 *supra*, and then selling another contract in the desired replacement delivery month. This simultaneous buy and sell has the effect of maintaining a long position but changing the delivery date to a different (more distant) month.

172. *Compare* Rev. Rul. 77-185, 1977-1 C.B. 48 *with* cases cited in note 170 *supra*.

173. 1971-2 C.B. 312.

174. *Id.*

clear. The cases in which the IRS has successfully argued against application of the wash-sale rule to commodity futures involve net long futures positions offset by short positions in the physical commodity or spot market.[175] These transactions have the same offsetting balance as straddles in which both long and short positions are in futures. Such positions are commonly assumed by businesses hedging their inventories.[176] Revenue Ruling 77-185 indicates that the IRS will no longer follow its earlier position or that the IRS seeks to limit it to balanced positions involved in hedging.

Congress has declared that futures contracts for delivery in different months are not substantially identical property for purposes of the short-sale rule of section 1233 of the I.R.C.[177] The section specifically exempts intermarket spread or straddle transactions in commodity futures from the short-sale rules.[178] Many intermarket spreads may entail fewer risks than time spreads within a market and are just as likely to create tax advantages, yet the positions involved are specifically not treated as substantially identical assets under I.R.C. section 1233.[179]

Both Revenue Ruling 71-568 and the interpretation of section 1233 of the I.R.C. suggest that commodity futures contracts for different months are not identical property and therefore are not susceptible to a wash-sale rule.[180] Furthermore, the wash-sale rule, like the closed-transaction analysis, relies on the naive assumption that switching a

175. See notes 170-71 *supra* and accompanying text.

176. See text accompanying notes 27-29 *supra*.

177. *See* I.R.C. § 1233(e)(2)(B); Treas. Reg. § 1.1233-1(d)(2) (1956).

178. I.R.C. § 1233(e)(3).

179. *See* FUTURES GAME, *supra* note 14, at 222-23.

180. The Supreme Court has never addressed whether the wash-sale rule now codified in section 1091 applies to such transactions. The Courts of Appeals for the Sixth and Second Circuits are in conflict on the issue. In *Trenton Cotton Oil Co. v. Commissioner*, the Court of Appeals for the Sixth Circuit, over the objections of the IRS, applied the wash-sale rule of section 1091 to commodity futures switches in hedging transactions. 147 F.2d 33, *rev'g* 2 T.C.M. 1172 (Dec. 28, 1943), *aff'd on rehearing*, 148 F.2d 208 (5th Cir. 1945). On rehearing the IRS argued:

> (a) that in each switching transaction, the date of delivery . . . in the contract purchased was later than in the contract sold, thus the contracts matured at different times;
>
> (b) that in some instances when one contract was sold and a new one purchased on the Commodity Exchange, the parties were different;
>
> (c) new purchases substituted for old had an additional charge for storage because the period of storage was longer.

148 F.2d at 209. The court disagreed, characterizing the futures contracts as essentially identical because they involved "materially or substantially the same property," and "the admitted facts show[ed] that the purpose of petitioner . . . was to avoid a loss." *Id.*

Several years later, in *Corn Prods. Ref. Co. v. Commissioner*, the Court of Appeals for the Second Circuit rejected the reasoning of the Court of Appeals for the Sixth Circuit and held that the wash-sale provision was not applicable. 215 F.2d 513, 516-17 (2d Cir. 1954), *aff'd on other grounds*, 350 U.S. 46 (1955). The Supreme Court affirmed the appellate court holding on an alternate ground and did not address the wash-sale issue. 350 U.S. 46, 47 (1955).

straddle always results in creating an economic situation identical to the original straddle. It is doubtful that the IRS's attempt to argue for a closed-transaction analysis as a euphemism for a wash-sale rule will withstand judicial scrutiny.

In *Smith v. Commissioner*, the Tax Court found the judicial, statutory, and administrative precedent concerning the closed-transaction analysis persuasive. The court held that the straddle switch resulted in the closing of the old straddle positions for tax purposes and that gain or loss was sustained at the time the positions were closed despite the presence of a continuing straddle.[181]

D. *Applicability of the Step-Transaction Doctrine.*

By characterizing each of the transactions required to complete a tax straddle as discrete steps under a step-transaction analysis, the IRS could sidestep the difficult profit-motive analysis and more accurately distinguish actual losses from nominal ones.[182] The judicially created step-transaction doctrine is particularly appropriate in analyzing the true economic substance of mixed-motive, multi-step transactions.

The step-transaction doctrine is generally characterized in two ways.[183] Under the end-result theory, the courts apply the step-transaction doctrine when there exists a series of related steps designed and executed as part of a unitary plan to achieve an intended result.[184] The court views the steps as a single whole transaction and adjusts the tax consequences appropriately.[185] Under the interdependence theory, the court considers the objective facts and circumstances to determine whether "the legal relations created by one transaction would have been fruitless without a completion of the series."[186] The step-transaction doctrine is a specific application of the broad judge-made "form over substance" approach to business transactions.[187]

---

181. Smith v. Commissioner, [Regular Decisions] TAX CT. REP. (CCH) No. 38,835 (78 T.C. No. 26, March 5, 1982).

182. *See also* Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 INST. ON FED. TAX. 247 (1954).

183. Levin & Bowen, *Taxable and Tax-Free Two-Step Acquisitions and Minority Squeeze-Outs—The Tax Aspects*, 36 INST. ON FED. TAX. 865, 870-71 (1978). A third approach, the binding-commitment theory, is limited to certain reorganizations and would not be applied to straddle transactions. *See* Commissioner v. Gordon, 391 U.S. 83, 96 (1967).

184. Kuper v. Commissioner, 533 F.2d 152, 155-56 (5th Cir. 1976).

185. *Id.*

186. American Bantam Car Co. v. Commissioner, 11 T.C. 397, 405 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

187. *See* Rev. Rul. 79-250, 1979-2 C.B. 156. *See also* Gregory v. Helvering, 293 U.S. 465 (1935).

The Tax Court recently applied the step-transaction doctrine in *Hassen v. Commissioner*.[188] The court disallowed a loss claimed by a taxpayer who lost property because he defaulted on mortgage payments but who later indirectly repurchased the property. At the foreclosure sale, the property was sold to the mortgagee for a sum equal to the remaining mortgage balance. The taxpayer claimed a substantial loss equal to the difference between his original basis in the property and his outstanding mortgage debt at the time of the default. The mortgagee later sold the building to a closely-held corporation controlled by the taxpayer for the amount of the outstanding mortgage balance plus foreclosure expenses.[189]

The IRS disallowed the taxpayer's loss under section 267(a)(1) of the I.R.C., which disallows losses from sales of property to persons related to the seller. The IRS argued that the taxpayer had, in effect, repurchased the property himself and that because no change had occurred in his net economic position, no loss could be claimed from the original foreclosure.[190]

The taxpayer argued that his corporation's purchase of the property did not invalidate his loss claim because his corporation bought the building from an independent third party in a "separate and independent sale."[191] The Tax Court, applying the step-transaction doctrine, rejected this contention.[192] The court held that the sales, though legally independent, must be considered as components of the same transaction. Referring to evidence of an informal plan on the part of the taxpayer and his mortgagee for the later repurchase and to the fact that the taxpayer suffered no genuine economic loss from the various component transactions when taken as a whole, the court disallowed the claimed loss.[193]

The taxpayer's situation in the *Hassen* case is analogous to that of a taxpayer who derives tax benefits from trading straddles. Both situations involve a taxpayer who faces little or no real economic loss, but who seeks to treat loss-producing steps in his transaction and other offsetting steps as having independent tax consequences despite their clear interdependence.

The step-transaction doctrine is broader than closed-transaction analysis and can be applied even if the taxpayer can demonstrate that he is in a different economic position after the transaction. Under step-

188. 63 T.C. 175 (1974), *aff'd*, 599 F.2d 305 (1979).
189. 63 T.C. at 178-79.
190. *Id.* at 183.
191. *Id.* at 182.
192. *Id.* at 189-90.
193. 599 F.2d at 309.

transaction analysis the court reviews all the steps of a transaction in combination. Despite the technical legal finality of one particular step, the court can determine that the step does not stand alone in a practical sense because it is part of a prearranged series that would never have been undertaken except with the intention of completing the series.[194] To defend his claimed straddle losses against a step-transaction attack, the taxpayer must demonstrate that not only did he intend to profit from the overall straddle trading but that each step was motivated by separate, legitimate economic purposes.[195]

Even a showing of independent economic significance does not always preclude a step-transaction analysis. Courts have combined steps despite the showing that each of the steps had some independent economic significance.[196] If straddle transactions are examined under a step-transaction analysis, courts can disallow claims of losses incurred in a transaction with some economic significance when it appears that the true economic substance of the transaction is best comprehended by viewing it as a step in a series of steps. Under a step-transaction analysis the courts may ignore economically significant losses created by switching delivery months in a straddle by combining them with the corresponding gains realized in later straddle steps and only recognizing the tax consequences of the entire series. This approach would reflect more accurately the true economic substance of the transactions.

The *Smith* court briefly considered the application of the step-transaction analysis to the taxation of straddle transactions. The IRS apparently suggested the analysis as an alternative approach should the court reject the closed-transaction analysis.[197] Unfortunately, the court linked the step-transaction analysis to the discredited closed-transaction and wash-sale analyses and dismissed it with little independent examination.[198]

194. This would indicate that the loss claimed in rolling the straddle was not a genuine economic loss. *See* Hassen v. Commissioner, 599 F.2d at 309. See note 186 *supra*.

195. Rev. Rul. 79-250, 1979-2 C.B. 156, 157; *cf.* Rev. Rul. 78-330, 1978-2 C.B. 147 (if transactions in a series have independent economic substance they will usually be given substance for tax purposes).

196. *See, e.g.*, King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969).

197. *See* Smith v. Commissioner, [Regular Decisions] TAX CT. REP. (CCH) No. 38,835 at 2862, 2871 (78 T.C. No. 26, March 5, 1982).

198. *See id.* at 2866-67, 2871-73. The court may have been reluctant to extend this judge-made doctrine into a new area, or its dismissal may have been due to a misapprehension concerning the applicability of the doctrine in a situation where the outcome of a series of steps was not perfectly predictable. *Id.* at 2872. However, in Hassen v. Commissioner, 63 T.C. 175 (1974), *aff'd*, 599 F.2d 305 (9th Cir. 1979), the Tax Court recognized that a step-transaction analysis is applicable where the agreements necessary to complete successfully all the steps are not binding and, therefore, the scheme may entail some risk of failure. *See* 63 T.C. at 189-90. See notes 188-93 *supra* and accompanying text.

The court concluded that "prior case law and statutes do not require the integration of. . . straddle losses."[199] Of course case law and statutes are least helpful when dealing with a previously undetected abuse since they would address only the form of the transaction. The step-transaction doctrine, however, like other judicial creations which counter the elevation of form over substance, is useful where statutory and case law concerning the form of the transaction compel a tax treatment that is inappropriate from a substantive view.[200] The tax straddle's creative use of offsetting positions and selective realizations to exploit the form of commodity futures trading make it an ideal candidate for analysis under step-transaction principles. The *Smith* court, in fact, used a step-transaction analysis when it examined the profit motive inherent in a tax straddle.[201]

Even if the courts conclude that the step-transaction doctrine should not be applied to straddle transactions in general, courts should apply it whenever they determine that the transactions comprise a tax straddle.[202] By following such a rule the courts would avoid difficult evaluation problems.[203] They also would avoid imposing double taxation on tax straddlers who fail to meet the requirements of the profit-motive test by integrating the first year's losses with the second year's gains rather than dealing with each independently.[204] Finally, use of the step-transaction doctrine would allow the courts to tax accurately the mixed-motive tax straddler despite the presence of profit motive in his transactions.[205]

IV. CONCLUSION

The tax straddle is an economically significant transaction. The tax straddler claims losses, however, that are unrelated to his actual economic condition by claiming that the decrease in value of one leg of

199. [Regular Decisions] TAX CT. REP. (CCH) at 2873.

200. See notes 182-87 *supra* and accompanying text.

201. We agree with respondent that what petitioners invested in with Merrill Lynch were commodity tax straddles—i.e., a prearranged, planned sequence of trading along the lines studied by respondent's expert'. . . . For purposes of section 165(c)(2), then, we hold the relevant "transaction" to encompass petitioners entire commodity tax straddle scheme.

[Regular Decisions] TAX CT. REP. (CCH) at 2874.

202. *Id.* Step-transaction doctrine as other form-over-substance doctrines should be invoked when transactions formally of one nature are misused to avoid the otherwise applicable tax rule. *See* Gregory v. Helvering, 293 U.S. 465 (1935).

203. See notes 140-49 *supra* and accompanying text.

204. *Id.*

205. See notes 54-65 *supra* and accompanying text.

the straddle is a loss for income tax purposes. Recognizing the artificiality of the claimed loss, the IRS has attacked its validity.

By arguing in Revenue Ruling 77-185 that the straddle transaction used in creating the loss has no economic substance, the IRS has taken a losing position. The IRS's closed-transaction analysis is an attempt to apply an objective and therefore easily administrable wash-sale rule to straddles. But the effort is based on the false assumption that straddle positions in different months have identical economic significance.

The IRS's profit-motive analysis was modified and accepted by the Tax Court in *Smith v. Commissioner*. The *Smith* opinion only justifies use of the profit motive analysis to disallow straddle losses in the most blatant cases. In any case where it is applied, the disallowance of straddle losses under a profit-motive analysis will also create the harsh result of double taxation. The more sophisticated tax-motivated straddlers incorporate an element of risk, and thus profit potential, into their transactions (particularly those entered into after the publication of the ruling).[206] The tax straddle is attractive because it produces large nominal gains and losses that are unrelated to its smaller but real economic gains and losses. When the smaller economic gains and losses exist, the profit-motive attack fails and the tax benefits from the nominal losses continue.

Of the possible judicial attacks on the validity of nominal straddle losses, only the step-transaction analysis succeeds without significant theoretical or practical flaws. The step-transaction analysis addresses the relationship of the claimed loss to the actual economic gain or loss of the entire group of transactions that constitute the tax straddle. Under step-transaction analysis, the courts can ignore complete, valid transactions, such as the closing at a loss of a commodity futures contract, in favor of assessing the tax consequences of a straddle that is entirely closed out.

Richard W. Evans

206. After the IRS issued Revenue Ruling 77-185, investors began building a degree of risk into their tax-straddle transactions to withstand IRS challenges based on profit motive. See *Futures Shock*, *supra* note 13, at 25.