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The BOXX Anomaly: ETF Tax Enhances Inverted Yield Curve Strategy

by Mark Leeds

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The BOXX Anomaly: ETF Tax Enhances Inverted Yield Curve Strategy

by Mark Leeds

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Mark Leeds is a tax partner with the New York office of Mayer Brown LLP. He thanks Vadim Novik, Lee Sheppard, Jason Bazar, and Brian Kittle for their comments on this report.

In this report, Leeds explores the federal income tax considerations presented by an investment in BOXX, an exchange-traded fund that uses existing transaction structures to achieve a high degree of tax efficiency.

The views and opinions expressed herein are solely the author's and should not be attributed to Mayer Brown or anyone else. The author did not contact BOXX about the description of the transactions contained in this report. Any mistakes and omissions are the author's sole responsibility.

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Excessive Federal Reserve Bank tightening creates bond market anomalies. Economic theory (and reality) supports higher returns for amounts placed at risk for longer terms. Accordingly, the yields on one- to three-month Treasury securities should look paltry to investors with time horizons of a year or more, even if the short-term returns are tax enhanced. For the past two years, the yield curve has been inverted, short-term returns currently exceed 5 percent, and one-year returns are 3.5 percent. In this interest rate environment, the ability to receive the short-term yield on a perpetual security looks like a home run. Add tax deferral and potential character conversion to the game, and it's likely to be a sure winner. Enter the Alpha Architect 1-3 Month Box ETF, an exchange-traded fund traded on the Nasdaq exchange under the ticker "BOXX."

BOXX replicates the return on short-term Treasury securities. Further, BOXX potentially allows its noncorporate shareholders to treat these returns as tax-favored, long-term capital gains if they hold for more than a year. In light of the current highly inverted yield curve, BOXX has successfully amassed over $3 billion in net assets from investors hoping to benefit from this strategy.[1] This report explores certain tax considerations to BOXX and its shareholders.

Publicly traded and retail open-ended mutual funds (regulated investment companies) often find that investment advisers judge them based on tax efficiency as well as raw investment performance. This has become especially true in today's crowded market in which many firms

[1] Lan Anh Tran and Margaret Giles, "BOXX ETF: Cashlike Returns Without the Tax Bill," *Investing Insights*, July 12, 2024.

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offer exposure to the same strategies or market segments. One strategy that many RICs have used to rationalize their tax liabilities is the creation-redemption transaction.[2] That type of transaction can substantially reduce the taxable income that a RIC would pass through to its shareholders without affecting its own investment strategy. To understand the BOXX trading strategy, one must understand how creation-redemption transactions are taxed. So I'll begin there.

I. Quick Background on RIC Taxation

The BOXX strategy is premised on BOXX's ability to pass along appreciation in certain of its option positions to its market maker without incurring a tax itself. If this can be successfully accomplished to the extent of the RIC's taxable income, the RIC will not have an obligation to make taxable distributions to its shareholders to zero out its own tax liability. This section discusses the basic milieu in which RICs operate and how they use distributions to ameliorate corporate-level tax.

A RIC is required to make dividend distributions to its shareholders of at least 90 percent of its investment company taxable income and its gross tax-exempt interest income.[3] If the RIC meets this distribution requirement and other requirements to be treated as a RIC, the dividend is deductible to the RIC.[4] Instead, the dividend is taxed to the shareholders.[5] The RIC can designate how much of its dividend is attributable to its receipt of qualified dividend income (QDI).[6] The shareholders can then treat that portion of the dividend as such.[7] For noncorporate shareholders, this is a distinct advantage because QDI is taxed at the lower marginal rates applicable to long-term capital gains. Ordinary RIC dividends are ineligible for this benefit.

A substantially similar regime applies to capital gains. A RIC can designate a dividend as a capital gain dividend to the extent of its long-term capital gain.[8] The RIC then reduces the amount of its capital gain potentially subject to tax in its hands by the amount of the capital gain dividend.[9] A capital gain dividend is treated as a long-term capital gain by the shareholders receiving that dividend.[10] Ignoring Social Security taxes, for noncorporate taxpayers, long-term capital gains are taxed at significantly lower rates (no greater than 20 percent) than ordinary income (taxed at up to 37 percent).[11]

The ability of a RIC to distribute its income to its shareholders and avoid being taxed as a corporation more generally places RICs in a class of entities known as "modified passthroughs." These entities are not true passthroughs, like partnerships, which pass through income to their partners that is not distributed. Instead, RICs must distribute their earnings to avoid being taxed themselves. It turns out that this is an imperfect tax regime. The creation-redemption transaction minimizes the friction inherent in a modified passthrough regime and achieves a shareholder-only level of tax when and if the shareholder disposes of their RIC shares.

II. Enter Section 852(b)(6)

Now that we've explored the basic taxation scheme for RICs, we turn to a congressional effort to ameliorate the impact of shareholder turnover, which can cause adverse tax results for nonredeeming shareholders. Specifically, Congress has enacted, and then reenacted, a code provision that permits RICs to pass appreciated securities to shareholders without incurring an entity-level tax. When a RIC takes advantage of this rule, it redeems an amount of its stock equal to the fair market value of the securities that it distributes in the redemption.

[2] One set of reporters has concluded that there were more than 500 creation-redemption transactions undertaken in 2018, which exempted from tax more than $211 billion in capital gains earned by RICs. *See* Zachary R. Mider et al., "The ETF Tax Dodge Is Wall Street's 'Dirty Little Secret,'" *Bloomberg News*, Mar. 29, 2019.

[3] Section 852(a)(1). Investment company taxable income excludes capital gains. Section 852(b)(2)(A).

[4] Section 561(a).

[5] Section 61(a)(7).

[6] Section 854(b).

[7] Section 1(h)(11)(D)(iii).

[8] Section 852(b)(3)(C).

[9] Section 852(a)(3)(A).

[10] Section 852(b)(3)(B).

[11] Section 1(h)(11)(1)(D).

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Section 852(b)(6), first enacted in 1969 and updated in 1986 (in each case, apparently to ameliorate the impact of the *General Utilities*[12] repeal on RICs),[13] provides that section 311(b) does not apply to any distribution by a RIC if the distribution is in redemption of the RIC's stock "upon the demand of the shareholder." Section 311(b) requires a corporation to recognize gain when it distributes appreciated property to a shareholder "in respect of" its stock. This provision applies to all distributions (other than complete liquidations described in section 332 and in the unlikely event that a RIC could consummate a tax-free spinoff under section 355), including distributions in redemption of stock. Accordingly, if a RIC redeems a shareholder by distributing appreciated securities, the RIC does not recognize any gain inherent in the securities distributed in the redemption. The tax rules do not impose a requirement that the distribution be pro rata to all shareholders.

This provision makes perfect sense in a variety of circumstances. For example, assume that a long-term shareholder of an open-ended RIC purchased 1,000x shares for $10x. The shares appreciate to $15x. The appreciation is attributable to appreciation in the securities held by the RIC. First, let's observe what would happen if the RIC sold securities with a basis of $10,000x and an FMV of $15,000x and distributed the $15,000x to the redeeming shareholder in redemption of its stock. The RIC would recognize a gain of $5,000x. Regardless of whether the RIC made a capital gain dividend in that year, substantially all this gain would be subject to tax in the hands of all the RIC's shareholders *with the exception of the redeeming shareholder*.[14] The redeeming shareholder would likewise recognize gain of $5,000x on the sale of its RIC shares.[15]

[12] *General Utilities and Operating Co. v. Helvering*, 296 U.S. 200 (1935).

[13] I could not locate any legislative history for section 852(b)(6).

[14] *See* section 852(b)(3)(D) (only persons who are shareholders of the RIC on the last day of its tax year are taxed on undistributed capital gains).

[15] Section 302(b)(5). Other commentators have also focused on the fact that section 852(b)(6) does not affect the gain that RIC shareholders will be required to recognize upon a disposition of their RIC shares. Morgan Lewis, "Tax Proposals May Affect Exchange-Traded Funds," Lawflash (Sept. 22, 2021).

This passing of the inside gain from redeeming to nonredeeming shareholders in an open-ended RIC can be partially mitigated by a tax equalization election by the RIC. A RIC making this election passes through a proportionate share of its then-undistributed recognized capital gains to shareholders redeeming stock before year-end.[16] The equalization credit used to reduce the year-end capital gain distributions is the actual number of shares redeemed divided by the total outstanding shares multiplied by the total undistributed realized gains in the fund as of the redemption date. Accordingly, the tax equalization election, although beneficial, does not apply to unrealized capital gains.

In this case, we can see how the modified passthrough entity structure fails to achieve the elegance of a single level of tax on the shareholders who benefited from the income. And worse than double taxation of the person who generated the gain, the gain attributable to one person (the redeeming shareholder) can be taxed to other persons (the nonredeeming shareholders). Section 852(b)(6) enables the RIC to cure this malady by forgoing taxation at the RIC level in favor of the tax borne by the redeeming shareholder, assuming that the RIC shareholder is willing to accept an in-kind redemption. The defect in section 852(b)(6) in this circumstance, however, is that the exemption at the RIC level is not predicated on gain recognition by the shareholder.

Section 852(b)(6) also has virtue for ETFs and other closed-ended RICs. (A closed-ended RIC is one that does not provide liquidity by generally allowing share redemptions.)

Starting with the same facts used earlier, the shareholder sells his RIC shares in an open market transaction for $15,000x and recognizes $5,000x of gain. The RIC still holds the appreciated securities, and when it sells them, it will end up passing through the gain to the other shareholders (now including the purchaser of the RIC stock). As a result, the gain to be recognized by the other shareholders will be overstated.

[16] *See* section 4982.

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When an ETF or closed-end fund has had substantial share turnover, it can proactively use section 852(b)(6) to prevent its shareholders from being taxed on income they did not earn. The RIC can turn to a broker or dealer that is an "authorized participant" under SEC rules to engage in the following set of transactions: The ETF will issue its stock directly to the authorized participant (the creation transaction). After waiting for some period of time, the authorized participant will tender the shares to the ETF for redemption (the redemption transaction).[17] The ETF distributes the appreciated securities to the authorized participant. The authorized participant (1) has no significant gain or loss on the redemption, (2) takes a basis in the distributed securities equal to the FMV of the distributed securities, and (3) promptly sells those securities (which it likely hedged on the creation transaction). Again, all is well in tax land — modified passthrough treatment has been preserved.

In a competitive market, a RIC with a lower tax burden will be more popular with investors than one with a higher tax burden. So why should a RIC limit its use of creation-redemption transactions to avoiding double taxation? A RIC could use creation-redemption transactions to shelter the gain on all (or substantially all) its appreciated positions. If the RIC is terminating those positions, a creation-redemption transaction is far more tax efficient than a regular-way sale. If the RIC is not terminating the positions, it can still use a creation-redemption transaction coupled with a reestablishment of those positions. The wash sale rules would not prevent the use of this strategy because those rules apply only to dispositions of securities sold at a loss.[18]

To illustrate how section 852(b)(6) could be used in the manner outlined above, assume that a RIC holds securities with a basis of $10,000x and an FMV of $15,000x. It has no other assets and no income or gains. An authorized participant purchases $15,000x of ETF stock from the RIC for cash or cash-equivalent securities. The RIC now holds the appreciated securities and $15,000x in cash. After some period of time has expired, the RIC redeems the stock held by the authorized participant for the appreciated securities and uses the $15,000x of cash to replace that portfolio at FMV. In these transactions, the ETF has not changed its economic position but has zeroed out its own tax liability and that of its shareholders (until the shareholders sell their RIC shares). Note that the gain inherent in the RIC shares has been preserved and will be taxed when the shareholders sell their RIC stock.

The situation becomes even more interesting when the shares of the ETF or closed-ended RIC trade at a discount to the ETF's net asset value. In this case, the authorized participant can buy the ETF shares in open market transactions (and thereby provide price support for the shares). The authorized participant then redeems the shares for their net asset value, capturing the discount as income and simultaneously providing the ETF the opportunity to eliminate its shareholders' tax liability as well as its own. The fact that the authorized participant can capture the discount should lessen the embedded fees the ETF would otherwise have to pay in the transactions. (In general, RICs do not pay fees in creation-redemption transactions because of securities law limitations.)

Some commentators have argued that a RIC's ability to avoid section 311(b) through creation-redemption transactions results in an inappropriate tax shelter.[19] That conclusion, however, depends on your perspective. If one starts with the premise that RICs should achieve a single level of taxation, redemption-creation transactions are not abusive; they serve the valuable purpose of ensuring that there is no tax at the RIC level. It's important to remember that creation-redemption transactions do not lessen the gain recognition by shareholders when they sell their shares. It's only if one starts with the premise that the RIC rules should tax shareholders currently on turnovers of the RIC's

[17] In some instances, the time between creation and redemption has been short. Some commentators have referred to creation-redemption transactions as "heartbeat" trades because the time between creation and redemption was no longer than a single heartbeat. Mider et al., *supra* note 2. Another report states that there was a two-day wait between a $3 billion creation transaction and its corresponding redemption. *See id.*

[18] *See* section 1091(a).

[19] *See* Lee A. Sheppard, "ETFs as Tax Dialysis Machines," *Tax Notes Federal*, Nov. 11, 2019, p. 909.

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portfolio that creation-redemption transactions should be seen as abusive. Current taxation of portfolio turnovers seems antithetical to the way investors view RICs.[20]

III. IRS Policing of Section 852(b)(6)

It is not entirely clear what the IRS could or should have done to police creation-redemption transactions. When closed-end funds have affirmatively used section 852(b)(6) to prop up ETF shares trading at a substantial discount and have sought an IRS private ruling on distributing securities in redemption of the ETF shares, the IRS has adopted guardrails as a precondition to issuing private rulings. Specifically, it required the ETF to represent that:

> The aggregate federal income tax basis that, as a percentage of Fund's aggregate federal income tax basis in all its assets prior to a tender offer, is no more than 1 percentage point lower than the percentage of the assets that are being distributed by Fund. For example, if a total of 50 percent of Fund's assets are distributed pursuant to a tender offer, Fund's aggregate federal income tax basis in all assets distributed in the tender will equal not less than 49 percent of the Fund's aggregate tax basis in all its assets prior to the tender offer.[21]

It's impossible to attribute any substantive basis to this standard other than the IRS's fear that if it provided private rulings without any limitations on the securities being distributed, the RICs would distribute securities with the highest basis-value disparities first. And why wouldn't they? There is no statutory rule requiring that the securities with the highest basis relative to value be redeemed first. The IRS seems to be requiring that RICs represent that they have not cherry-picked the securities to be redeemed. But again, so what if the RIC did cherry-pick? The results should not change if the most appreciated securities are distributed first.

The Supreme Court's recent overriding of the *Chevron* doctrine in *Loper Bright*,[22] and the Tax Court's consideration in *Varian* of the IRS's ability to police transactions that meet the literal requirements of a statute,[23] may restrain the IRS's ability to limit creation-redemption transactions. In *Varian*, the Tax Court invalidated reg. section 1.78-1 in an arguably analogous situation to creation-redemption transactions. The *Varian* decision considered the interaction of sections 78 and 245A and held that the IRS had no authority to implement a "fix" to statutes to prevent a double deduction for foreign taxes when the language of the statutes clearly permitted those deductions. Specifically, section 245A permits a deduction for dividends paid to a U.S. corporation by a foreign corporation for distributions made after December 31, 2017. To prevent a corporation from deducting the dividend and foreign taxes deemed carried out by distributions, Congress amended section 78 to preclude a U.S. corporation from claiming a dividend paid deduction made in tax years beginning after December 31, 2017. This statutory scheme left open the possibility for non-calendar-year taxpayers to claim a deduction for dividends paid after December 31, 2017, and claim a deemed foreign tax deduction for dividends paid after that date when the taxpayer's tax year extended past December 31, 2017. The taxpayer was in such a position and claimed a double deduction for a dividend paid to it from a non-U.S. subsidiary after December 31, 2017, but in the tax year that ended after that date.

To foreclose the potential double deduction provided by the interaction of the effective dates for sections 78 and 245A, the IRS amended reg. section 1.78-1 to provide that a section 78 dividend is not treated as a distribution for purposes of section 245A if paid after December 31, 2017, even though the statute mandated that result only if the section 78 dividend was paid in a tax year ending after that date. The Tax Court found that the regulation gives "section 78 an earlier effective date than provided for in the [Tax Cuts and Jobs Act] to

[20] *See* Elisabeth Kashner, "The Heartbeat of ETF Tax Efficiency," etf.com (Jan. 3, 2018).

[21] LTR 200536002; LTR 200509013 as amended by LTR 200536003; LTR 200414043; and LTR 200341014.

[22] *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024).

[23] *Varian Medical Systems Inc. v. Commissioner*, 163 T.C. No. 4 (2024).

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prevent taxpayers like Varian from deducting section 78 dividends." The court refused to give effect to the earlier effective date ostensibly mandated by the regulation, quoting the Supreme Court in saying that "self-serving regulations never 'justify departing from the statute's clear text.'" Citing *Loper Bright*, the Tax Court further held that a "'permissible' interpretation of a statute no longer prevails simply because an agency offers it to resolve a perceived ambiguity." Rather, the Supreme Court made clear that statutes "have a single, best meaning."

An attack on creation-redemption transactions could face the same reception in court as did the IRS's attack on the double dip in *Varian*. Section 856(b)(6) is simple and explicit: A RIC does not recognize gain on the distribution of appreciated property in a redemption. If the IRS sought to challenge the distribution of the gain leg of the single stock option straddle, it could face the same result as it did in *Varian*. It is up to Congress to repeal section 856(b)(6) if the results are deemed to be too advantageous. And legislation has been proposed, as discussed later.

If the IRS were to challenge creation-redemption transactions, it appears that the most fruitful avenues of attack would be the substance-over-form doctrine or the assertion that the authorized participant is acting as an agent of the RIC in selling the appreciated securities. If the authorized participant held the RIC shares issued in the creation transaction only for a heartbeat, it could be argued that the participant should not be treated as a shareholder for federal income tax purposes. The creation and redemption could be collapsed into a sale transaction in which the RIC would recognize gain. (The application of the step transaction doctrine would ignore the issuance of the RIC stock.) Along the same lines, the IRS could argue that the authorized participant was never a shareholder and that they sold the appreciated securities on the RIC's behalf. It's beyond the scope of this report to consider when a creation-redemption transaction lacks economic substance and should be recharacterized as a sale for federal income tax purposes. But what's the rub anyway? Ensuring that the RIC rules work to prevent double taxation?

IV. Legislative Developments

In 2021 Senate Finance Committee Chair Ron Wyden proposed repealing section 852(b)(6), effective as of December 31, 2022.[24] The summary accompanying the proposal cites a law professor who concluded that section 852(b)(6) "provides an unfair tax subsidy for ETFs and encourages the transfer of capital from other kinds of investment vehicle to ETFs. It also unfairly benefits high-net-worth owners of ETFs."[25] The Wyden proposal was not included in that year's House of Representatives markup of draft legislation for 2021. It would have been a blunt tool to address potential abuses of section 852(b)(6).

A commentator has proposed requiring RICs that take advantage of section 852(b)(6) to reduce their bases in their remaining securities by the gain sheltered by section 852(b)(6).[26] As far as I know, that proposal has not been considered in Congress.

V. Enter the Smartest Guys in the Room

Wesley Gray is a finance author and Marine Corps veteran with a doctorate in finance from the University of Chicago who leads at least two investment companies.[27] Formidable for sure. In late November 2022, his Alpha Architect (Alpha) investment management firm launched BOXX on the Nasdaq exchange. BOXX seeks to provide investment results that, before fees and expenses, equal or exceed the price and yield performance of an investment that tracks the one- to three-month sector of the Treasury bill market.[28] And with over $3 billion in assets, BOXX has delivered that investment return.[29] As we'll explore below,

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[24] *See* "Wyden Pass-Through Reform Discussion Draft," section 17 (Sept. 10, 2021).

[25] *Id.* (citing Jeffrey Colon, "The Great ETF Tax Swindle: The Taxation of In-Kind Redemptions," 122 *Penn. St. L. Rev.* 1 (2017).

[26] Steven Z. Hodaszy, "Tax-Efficient Structure or Tax Shelter? Curbing ETF's Use of Section 852(b)(6) for Tax Avoidance," 70 *Tax Law.* 537 (2017).

[27] Gray has said that he is a bona fide resident of Puerto Rico within the meaning of section 933(1). Mider, "T-Bills Without Tax Bills? This Fund Says It Cracked the Code," Bloomberg, Feb. 2, 2022.

[28] BOXX Prospectus, at 1 (Nov. 21, 2022). As far as my reading has discerned, BOXX does not make any statements regarding the generation of capital gains from a transaction in which substantially all of the shareholders' return is from the time value of money. On page 21 of the BOXX prospectus, however, there is a statement that a shareholder may recognize a capital gain on the sale of BOXX shares at a profit.

[29] Tran and Giles, *supra* note 1.

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BOXX uses creation-redemption by providing a debtlike return without current tax. Before the BOXX offering, creation-redemption transactions had been used to protect only against taxes imposed on gains attributable to stock and bond dispositions.

BOXX transacts in so-called box spreads. Box spreads generate a debtlike return by trading option pairs and not actually requiring the purchase of a debt instrument. In the first leg of the transaction, BOXX enters into a "bull call spread," which is a type of options trading strategy that involves two call options. The bull call strategy is executed by purchasing call options at a specific strike or exercise price while also selling the same number of calls of the same asset at a higher strike price. Both options should have the same expiration date. In the second leg of the transaction, BOXX enters into a "bear put spread." A bear put spread is achieved by purchasing put options while also selling the same number of puts on the same asset with the same expiration date at a lower strike price. The maximum profit using this strategy is equal to the difference between the two strike prices, minus the net cost of the options. Because the price of a box spread at its expiration will always be the distance between the strikes involved (for example, a 100-point box might use the 25 and 125 strikes and would be worth $100 at expiration), the price paid for the four options today can be thought of as that of a zero-coupon bond. The lower the initial cost of the box, the higher its implied interest rate. This concept is known as a synthetic loan.

Here is an example of a box spread: Company A stock trades for $51 per share. Each option contract in the four legs of the box relates to 100 shares of stock. The plan is to:

- buy the 49 call for 3.29 (in-the-money) for $329 debit per options contract;
- sell the 53 call for 1.23 (out-of-the-money) for $123 credit;
- buy the 53 put for 2.69 (in-the-money) for $269 debit; and
- sell the 49 put for 0.97 (out-of-the-money) for $97 credit.

The total cost of the trade before commissions would be $329 - $123 + $269 - $97 = $378. The spread between the strike prices is 53 - 49 = 4. Multiply 4 by 100 shares per contract = $400 for the box spread.[30] In this case, the trade can lock in a profit of $22 before commissions, regardless of price movements in the Company A stock. The commission cost for all four legs of the deal must be less than $22 to make this profitable. Thus, low-volatility stocks (whose options are less expensive than high-volatility stocks) are good choices for this strategy. The margins are razor thin, and this is only when the net cost of the box is less than the expiration value of the spreads or the difference between the strikes.

BOXX uses exchange-traded options backed by the Options Clearing Corp. (OCC). The OCC is rated AA, one notch below Fitch's rating of the federal government's debt. Accordingly, the market views the credit risk posed by BOXX's box trading strategy to be de minimis.

Even small bets can generate outsized capital gains and losses. Bloomberg has reported that on a single trade with only $1 million invested, BOXX's box options generated over $30 million in capital gains and losses.[31] That loss exceeded BOXX's actual returns for the year.[32]

VI. The Overlay

Everything else being equal, BOXX could deliver the gain positions on its box spread and pass the gain inherent in those positions to its authorized participant. As more fully described below, the options used by BOXX in its box spread transactions are treated as section 1256 contracts.[33] There is a substantial tax risk that even though section 856(b)(6) allows BOXX to distribute appreciated securities to a redeeming shareholder without incurring a tax, section 1256(c)(1) would require a taxpayer, even a RIC, to recognize the mark-to-market gain on section 1256 contracts disposed of in a redemption described in section 856(b)(6).

Since BOXX faces a substantial tax risk that the distribution of the appreciated legs of the box spread transactions would trigger the gain at the

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[30] I gratefully thank Investopedia for this example, which is taken and adapted from its website.

[31] Mider, *supra* note 27.

[32] *Id.*

[33] *See* section 1256(b)(1)(C).

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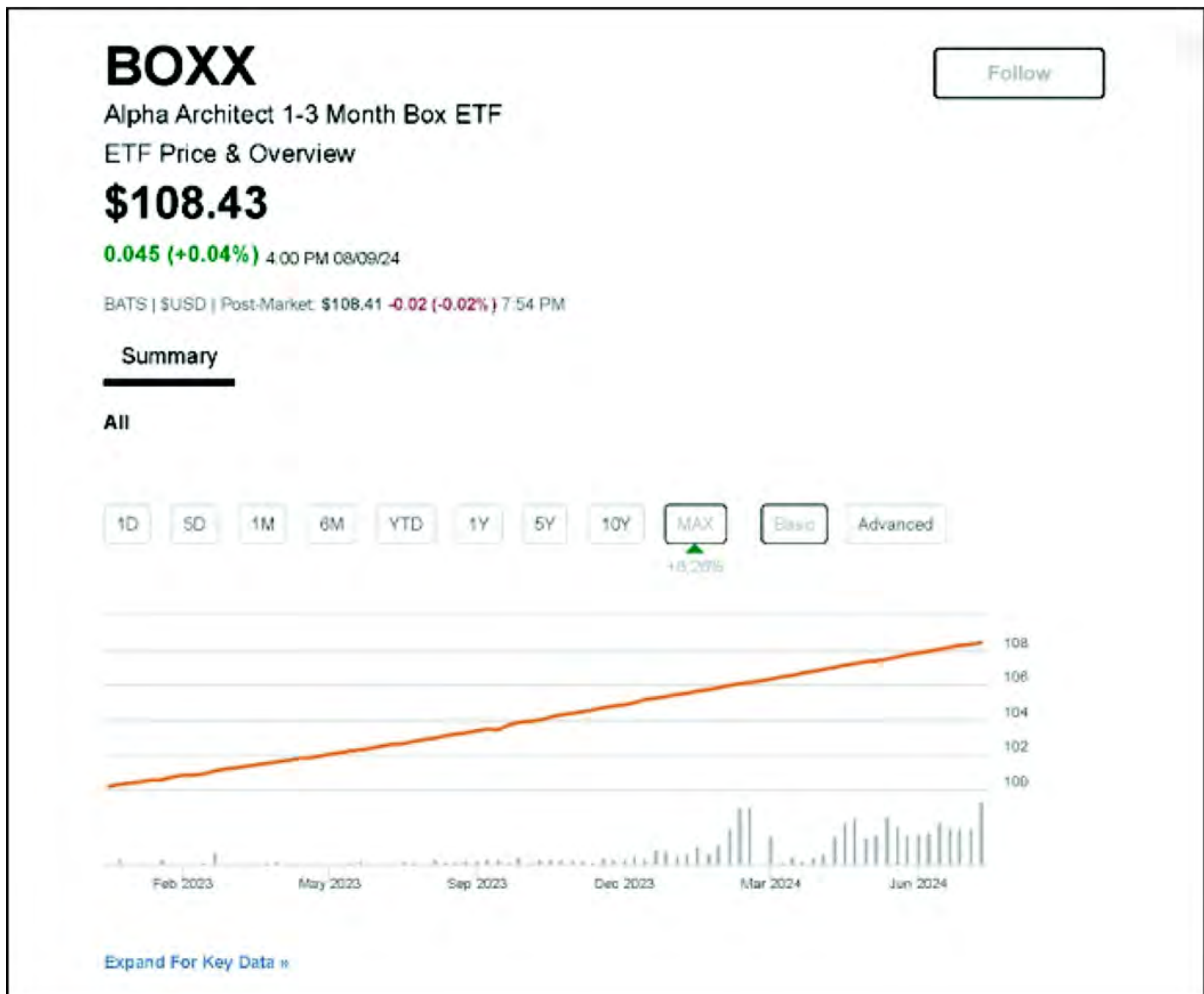

corporate level, it uses an unrelated straddle transaction to carry out the redemption. Specifically, BOXX buys call options on single-name stocks (which are not section 1256 contracts) and simultaneously sells put options on the same stocks. The puts and calls have the same strike prices and expiration dates. It appears that BOXX then enters into exactly the opposite positions — it sells calls and buys puts on the same number of shares. The combination of the offsetting positions is the same as being short against the box; there is no opportunity for gain or loss. When the expiration dates of these puts and calls approach, BOXX distributes the appreciated positions in a redemption described in section 856(b)(6). It then triggers the loss on the retained position, and that loss shelters the gain on the box spread transaction.

VII. The Results

If all goes according to plan, an investor in BOXX will earn a debtlike return on the BOXX share price. The shareholder will not receive any distributions or incur a tax liability before the sale of the BOXX stock. If the investor holds the BOXX shares for more than one year, they will have a long-term capital gain at redemption (subject to a maximum 20 percent income tax) instead of an up to 37 percent federal income tax on a current basis. Accordingly, if the BOXX strategy generates the anticipated tax results, the effective tax rate is only 54 percent of the ordinary income rate and is deferred.

How well has BOXX executed on its strategy? The figure shows a life-to-date chart of the BOXX stock price.

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In short, BOXX has performed in substantially the same manner as a zero-coupon bond accrues income — that is, on a straight line or level yield. But if an investor held a zero-coupon bond, it would be taxed on the accretion to value each year.[34] If BOXX works as anticipated, all income is deferred until the shareholder sells its stock.

VIII. Does BOXX Work as Planned?

Subject to the agency issues noted above, my view is that the market-standard, creation-redemption transaction is supported by the relevant authorities. But BOXX does not use those transactions to mitigate capital gains from risk positions in stocks or securities. Instead, it uses them to shelter gains from essentially riskless positions, providing a debtlike return. While there is some risk inherent when using creation-redemption transactions as part of this broader strategy, on the whole, a strong case can be made that BOXX should be successful in its tax strategy.

Several commentators have asserted that the deferral and conversion of ordinary income into long-term capital gain for investors from holding BOXX shares is negated by the conversion transaction rules of section 1258.[35] Section 1258(c) defines a conversion transaction as any transaction in which all the taxpayer's return is attributable to the time value of money and meets one of four specified filters:

1. the holding of property and the execution of a substantially contemporaneous contract to sell property at a price determined in accordance with that contract;
2. a straddle;
3. a transaction that is marketed or sold as producing capital gains from a transaction that meets the first test stated above; or
4. any other transaction designated by the IRS in regulations.

The legislative history accompanying the enactment of section 1258 elaborates on the first requirement:

> In a conversion transaction, the taxpayer is in the economic position of a lender — he has an expectation of a return from the transaction which in substance is in the nature of interest and he undertakes no significant risks other than those typical of a lender.[36]

A taxpayer's net investment in a conversion transaction "generally will be the aggregate amount invested by the taxpayer in the conversion transaction less any amount received by the taxpayer for entering into any position held as part of the conversion transaction." Accordingly, for any transaction to be treated as a conversion transaction, it must provide the taxpayer with a return akin to the yield that a lender would receive and not pose risks greater than those that a lender would normally bear.

If a transaction constitutes a conversion transaction, gain on the transaction is treated as ordinary income to the extent that the gain "does not exceed the applicable imputed income amount."[37] The applicable ordinary income amount is the excess of the yield the taxpayer would have received if it earned 120 percent of the applicable federal rate on its investment over any amount treated as ordinary income.[38] Given that the BOXX strategy seeks to mimic the yield on one- to three-month Treasury bills, it's likely that if BOXX or its shareholders were treated as engaged in conversion transactions, all their gain would be taxed at ordinary income rates.[39]

A. Shareholder-Level Analysis

It would be very difficult to argue that substantially all of an investor's return from an investment in BOXX is not "attributable to the time value of the taxpayer's investment in such transaction" within the meaning of section

[34] Section 1272(a).

[35] Steve Rosenthal, "BOXX's Tax Gimmick Violates Congress' Rules on Conversion Transactions," *Forbes*, Mar. 12, 2024; Daniel J. Hemel, "The Tax Trap Inside the BOXX," *Tax Notes Federal*, Mar. 11, 2024, p. 1973.

[36] S. Rep. No. 103-403, at 55 (1993).

[37] Section 1258(a) (flush language).

[38] Section 1258(b).

[39] At least one commentator has noted that the pretax BOXX yields are substantially below what an investor could receive if it purchased medium-term Treasury securities in lieu of holding BOXX for any appreciable time. This commentator concluded that even with the BOXX tax benefits, an investor would have a higher after-tax yield if it purchased longer-dated Treasury securities directly. Aaron Brown, "Save Taxes With BOXX? It Is Too Good to Be True," *Bloomberg Law News*, Mar. 14, 2024.

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1258(c)(1). The share return shown in the figure mimics the accretion to value that occurs on a zero-coupon bond, almost on a completely straight line. Accordingly, the first prong of the conversion-transaction test is likely satisfied.

BOXX shareholders appear to be standing on much stronger footing regarding other conversion-transaction tests. Unless the shareholder has entered into a forward contract to sell its BOXX shares, the two conditions necessary for the test in section 1258(c)(2)(A) should not be considered satisfied. The holding of the BOXX stock should not be considered a straddle under section 1092. Accordingly, the test in section 1258(c)(2)(B) should not be considered satisfied. The IRS has not issued any regulations specifying any transaction as a conversion transaction, rendering the test in section 1258(c)(2)(D) moot.

Section 1258(c)(2)(C) is more complicated because it seeks to discern what the investor was told about the tax treatment. The BOXX offering materials (prospectus) do not market the BOXX shares as producing capital gains. The prospectus for the BOXX shares states that a shareholder *may* recognize a capital gain on the sale of BOXX (emphasis added). In recent financial press interviews, however, Gray has made statements regarding the tax efficiency of BOXX relative to a direct investment in Treasury securities. Commentators have raised the issue of whether these statements amount to "marketed or sold" within the meaning of section 1258(c)(2)(C). However, I have seen nothing in the coverage of BOXX that could reasonably be construed as a representation that a shareholder will recognize a capital gain on the disposition of BOXX shares. Accordingly, while some uncertainty exists, the test in section 1258(c)(2)(C) should not be considered satisfied based on what has occurred to date.

The marketing test of section 1258(c)(2)(C) was considered in ILM 201501012. In that legal memorandum, the IRS considered the application of the conversion rules to a leveraged forward contract transaction. The transaction had two legs: (1) a zero-coupon loan obligation and (2) a prepaid derivative contract. The loan and derivative created offsetting or mutual obligations. A broker sold the prepaid derivative to the client, and the client paid for the derivative by tendering its debt obligation to the broker. Under the derivative contracts, the broker was required to deliver a bond or its cash equivalent on a specified date. The client was protected against loss by way of a floor built into the derivative contract. On the delivery date, the broker offset the amount due under the loan against the cash settlement amount due under the derivative contract. The dealer hedged its interest rate risk by entering into swaptions with a bank. The swaption and the loan exactly matched any amount that the dealer would be required to pay under the derivative contract.

The marketing materials for the leveraged prepaid forward contract represented that the client could deduct the interest on the loan against other income and that any gain on the prepaid forward contract would be long-term capital gain. The IRS took these statements to mean that "the promotional materials emphasize how investors in the Transaction are expected to receive a return on their investment primarily through tax benefits, rather than through potential Additional Payments." The promoter charged significant fees to allow an investor to participate in the transaction: Only 14 cents of each dollar invested went into the actual transaction. The remainder was used to pay fees.

One of the arguments promoted by the IRS in denying these tax benefits to the investor was that the transactions constituted a section 1258 conversion transaction. It concluded that the transaction was marketed as a conversion transaction because the marketing materials contained the following representations (as described by the IRS):

> There is "no market risk [on the prepaid forward contract,] and . . . loan payments are matched to the minimum payments guaranteed by the Forward Contract." The materials further project "After-Tax Net Cash Flow" due solely to exploiting the difference between deducting payments of interest on the Loan at ordinary rates (assumed to be 35 percent), and including in income the matching receipts under the Contracts as long-term capital gains (assumed to be taxed at a 15 percent rate).

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In contrast, the BOXX prospectus does not contain any representations about tax treatment and provides an economic return apart from the tax benefits.

B. BOXX-Level Analysis

In contrast to the shareholder-level analysis, it is not as clear that the box option strategy BOXX itself used should not constitute a conversion transaction under section 1258(c). As analyzed below, however, the answer is unlikely to matter. The passing out of the gain leg in the single stock option raises straddle issues. In my view, the straddle rules should not prevent the loss recognition by BOXX on the loss positions it retains. Further, the mark-to-market rules of section 1256 pose special considerations. It seems BOXX has navigated the section 1256 issues, which are addressed below.

1. Conversion transactions.

The box options themselves, when initiated, seem to offer no returns other than a return tied to the time value of the taxpayer's net investment in the transaction. It is unlikely that conversion transaction characterization would be avoided based on a conclusion that the transaction was not described in section 1258(c)(1). The single stock options are probably described in section 1258(c)(2)(B) — that is, they create an "applicable straddle" — because any gain or loss on one option should be offset by a loss or gain on the other option.[40] BOXX can recognize only the net return, which represents a time value of money return. Moreover, there is a risk that the box option strategy involves the holding of property while simultaneously entering into a contract to sell that property at a price determined in accordance with the contract. But options are not contracts obligating a taxpayer to sell property. Accordingly, the risk that the option strategy is described in section 1256(c)(2)(A) seems like less of a concern.

Section 1258(a), however, recharacterizes capital gain as ordinary income. BOXX does not recognize any gain. BOXX, by using section 852(b)(6), disposes of the gain leg of the box option position by redeeming its shares being held by an authorized participant without recognizing any gain. As a result, even though BOXX itself may have engaged in a conversion transaction, there is no gain at the BOXX level for section 1258(a) to recharacterize as ordinary income.

2. Straddle limitations.

Once BOXX clears the conversion-transaction rules, the next question is whether the straddle rules limit BOXX's ability to claim a loss on the closing of the positions not distributed in the creation-redemption transaction. The single stock positions certainly constitute a straddle within the meaning of section 1092(c). If the rules for straddles applied to BOXX, the loss from the positions it did not distribute in the creation-redemption transactions would be deferred until the unrecognized gain in the positions distributed were recognized.[41] There are open issues on the application of the straddle rules to the BOXX strategy. As analyzed below, however, the better answer is that BOXX should not be significantly limited in its ability to claim losses on retained positions based on the application of the straddle rules.[42]

Section 1091(a)(1) tests whether there is unrecognized gain at year-end. The first test for unrecognized gains looks to the positions "held by the taxpayer" at year-end.[43] In the case of single stock option transactions engaged in by BOXX, neither it nor any of its affiliates (within the meaning of section 1092(d)(4)) hold any offsetting positions with unrecognized gains at year-end. (In fact, no one does because the gain positions are distributed at fair value.) Accordingly, this test for the straddle loss deferral rule is unlikely to affect the tax results of the BOXX box option trading.[44]

The second test for unrecognized gains, contained in section 1092(a)(3)(A)(ii), has given certain practitioners concern, stemming from the language in section 1092(a)(3)(A)(ii). This

[40] The box option positions should not constitute a straddle, assuming that all the positions in the box option trading are section 1256 contracts. Section 1256(a)(4).

[41] Section 1092(a)(1).

[42] For a contrary position, see Hemel, *supra* note 35.

[43] Section 1092(a)(3)(A)(i).

[44] *See* Sheppard, "BOXX: ETF as Money Market Fund Substitute," *Tax Notes Federal*, Mar. 4, 2024, p. 1709.

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provision says unrecognized gain includes realized but not recognized gain, without regard to positions held by the taxpayer at year-end. Realized gain includes "in the case of any position with respect to which, as of the close of the taxable year, gain has been realized but not recognized, the amount of gain so realized." When a taxpayer engages in a redemption to which section 852(b)(6) applies, a concern arises that it has realized gain on the distribution, but section 852(b)(6) prevents the taxpayer from recognizing the gain. It's possible that the gain (which, from BOXX's perspective, is eliminated) is unrecognized gain, which would prevent the recognition of any losses on BOXX's retained built-in loss positions.

Even if this reading is correct, the statute implies, under the "realized by not recognized" language, that this results in only one year of deferral.[45] Specifically, at the end of the next year, the taxpayer is again considered to have sustained the loss. In that subsequent year, BOXX should not be considered to have incurred any unrecognized gain within the meaning of section 1092(a)(3)(A)(ii). Under this interpretation, even if the loss is deferred, when BOXX retests in the following year, there should be no unrecognized gain or realized gain in the year, so the loss should become available.

3. Section 1256 considerations to box option trading.

As stated above, it appears that the options BOXX is using in its box spread transactions are section 1256 contracts.[46] Listed options (that is, exchange-traded options) that relate to broad-based stock indices are treated as nonequity options under the regulations.[47] Using these section 1256 contracts in box spread transactions poses a risk to BOXX: If BOXX distributed the gain legs of these positions to redeem the BOXX shares held by the authorized participant, it would be required to recognize the gain inherent in the options, notwithstanding the exclusion from the application of section 311 provided by section 856(b)(6).

First, section 1256(c)(1) provides that a taxpayer recognizes gain or loss when it transfers its position under a section 1256 contract. (That gain or loss is 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.[48]) Thus, sections 1256(c)(1) and 852(b)(6), both of which should apply to the redemption, provide for opposite results. The Joint Committee on Taxation report accompanying the enactment of section 1256(c)(1) (the blue book) supports the conclusion that the gain/loss recognition rule of section 1256(c)(1) prevails: "These mark-to-market rules apply to a transfer notwithstanding that nonrecognition of gain or loss would result from the application of any other provision of the Code."[49]

However, the Supreme Court has held that reports by the JCT are not true legislative history and essentially have the same weight as a mere law review article. In *Woods*,[50] the Court accorded no deference to a JCT report, stating:

> We have held that such "post-enactment legislative history (a contradiction in terms) is not a legitimate tool of statutory interpretation." . . . While we have relied on similar documents in the past . . . our more recent precedents disapprove of that practice. Of course, the Blue Book, like a law review article, may be relevant to the extent it is persuasive. [Citations omitted.]

Many practitioners would be hesitant to conclude that section 856(b)(6) overrode the application of section 1256(c)(1).

On the other hand, options on narrow-based securities indices and single stocks are subject to section 1256 only if the holder of that option is an option dealer.[51] Since BOXX should not be treated as an option dealer, it does not face the potential for gain recognition to the extent that it is using options on narrow-based securities or a single stock. As described above, this appears to be part of the BOXX game plan. BOXX has disclosed that it buys puts and calls on single stocks. In

[45] *See* section 1092(a)(1)(B).

[46] *See* section 1256(b)(1)(C).

[47] Preamble to T.D. 9616, section C.2 (Apr. 27, 2013).

[48] Section 1256(a)(3)

[49] JCT, "General Explanation of the Economic Recovery Tax Act of 1981," JCS-71-81, at 297 (Dec. 29, 1981).

[50] *United States v. Woods*, 571 U.S. 31 (2013).

[51] Section 1256(g)(4)(B).

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particular, BOXX enters into offsetting options regarding Booking Holdings, a publicly traded company. BOXX buys calls and sells puts with identical strike prices and the same expiration dates. This trading prevents BOXX from recognizing any gains or losses on its Booking Holdings positions.

Shortly before the Booking Holdings options expire, BOXX uses the in-the-money position to redeem its stock. Because the Booking Holdings options are not section 1256 contracts, BOXX does not recognize any gain under section 1256(c)(1). It then closes the out-of-the-money Booking Holdings position at a loss. This loss is a capital loss. The loss recognized on the Booking Holdings position shelters the gain on the section 1256 contracts.

4. The single stock option transaction.

Last but certainly not least, it is worth considering whether BOXX's breaking apart a riskless transaction to take advantage of section 856(b)(6) provides a basis for the IRS to successfully challenge the use of section 856(b)(6). Although there is some uncertainty here, the BOXX transactions do not appear to fall within the type of transaction that would give the IRS a basis to challenge BOXX's strategy.

In *K2 Trading*,[52] the court concluded that a marketed transaction using options, referred to as son-of-BOSS, did not have economic substance. In that transaction, the taxpayers purchased European-style call options and sold European-style put options, each over foreign currency, from the same counterparty. On a net basis, the taxpayer incurred only a negligible cash expense. The options were contributed to a partnership. The taxpayer took the position that the basis in the partnership interest included the cost of the purchased call but was not reduced by the premium received from the sold put option. The partnership then distributed other property to the taxpayer in redemption of its partnership interest. The artificially high basis attached to the distributed property, which was sold at a tax loss. The tax loss was used to shelter other gains. These steps, and their tax consequences, followed literal rules in the code. After the transaction, the IRS designated it a listed transaction.[53]

There was some variation between the strike prices of the two options, which created the opportunity for a pretax profit on the option pair. In other words, the gain on one option would not necessarily be offset by a corresponding loss on the other option. The taxpayer asserted that this opportunity for profit created economic substance for the transactions. Experts testifying on behalf of the IRS opined that the opportunity for profit was limited.

The court held that the opportunity for profit on the call spread (that is, the option pair) did "not outweigh the other evidence of record demonstrating that the tax effects of the transaction were entirely fictional." The court went on to hold: "While lack of reasonable profit-making potential is one indicator that a transaction does not possess economic substance, *Stobie Creek*, 608 F.3d at 1378, potential for profit does not in and of itself establish economic substance — especially where the profit potential is dwarfed by tax benefits." In this case, the profit potential was at most $202,054, and the claimed tax benefit was an inflated basis of approximately $26 million.[54]

Palm Canyon X[55] involved a strategy similar to the one considered in *K2 Trading*. In *Palm Canyon X*, a taxpayer purchased offsetting digital (barrier) options through a disregarded entity. Another person purchased an interest in the disregarded entity, causing it to become taxable as a partnership. As in *K2 Trading*, the taxpayer took the position that the basis in the partnership interest included the cost of the purchased call but was not reduced by the premium received from the sold put option. Two months later, after one of the options went into the money and the other option expired worthless, the partnership liquidated and distributed the foreign currency received in exercise of the in-the-money option. The taxpayer claimed an overstated basis in the foreign currency and a large ordinary loss on the

[52] *K2 Trading Ventures LLC v. United States*, 101 Fed. Cl. 365 (2011).

[53] *See* Notice 2000-44, 2000-2 C.B. 255.

[54] *See also Jade Trading LLC v. United States*, 80 Fed. Cl. 11 (2007), *aff'd in part and rev'd in part on other grounds*, 598 F.3d 1372 (Fed. Cir. 2010).

[55] *Palm Canyon X Investments LLC v. Commissioner*, T.C. Memo. 2009-288.

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disposition of the foreign currency. Again, the purported tax consequences were supported by a literal reading of the code.

The strategy yielded a profit of $6,600[56] before the payment of $345,000 in expenses. The Tax Court tested whether the transaction had economic substance by asking two questions: (1) Did the transaction have economic substance beyond its tax benefits, and (2) did the taxpayer have a nontax business purpose for the transaction? The taxpayer's assertion that he entered into the offsetting options to become familiar with currency hedges was belied by the facts that he overpaid for the options, overpaid fees, and had no realistic plans to use foreign currency in his trade or business. Objectively, the court determined that it was impossible, or close to impossible, for the taxpayer to earn a profit on the transaction. Accordingly, the court determined that the transaction lacked economic substance.

In *Alpha I*,[57] the taxpayers executed short sales of highly appreciated stock. They then contributed stock, cash received in the short sale, and the open short positions to a partnership. The taxpayers took the position that their basis in the partnership interest received in exchange for the contribution was equal to the basis of the stock and the cash contributed, unreduced by the short sale liability. The short sales were then closed, and the taxpayers reported substantial losses on the short sales instead of the gains that would have resulted if the short sales had been closed outside the partnership. This was another son-of-BOSS transaction. The words of the code supported the tax consequences claimed by the taxpayers. Nonetheless, the court found that the sole motivation for the short sales, coupled with the contributions to the partnerships, was to try to turn substantial capital gains into capital losses. As a result, the court found that the transactions should be characterized as tax shelters within the meaning of section 6662(d)(2)(C)(ii).

In *Shasta Investment Fund*,[58] the taxpayers borrowed money at a very high interest rate in exchange for a cash "premium." The premium was equal to the amount of tax loss that the taxpayers desired to generate. The taxpayers then contributed the borrowed money (including the premium) subject to the debt to a partnership and took the position that their basis in the partnership interest was reduced only by the stated principal on the loan. (These transactions were referred to as bond linked issue premium structures, or BLIPS.) The partnership then engaged in foreign exchange transactions that had a de minimis probability of generating a profit. These transactions were terminated shortly thereafter, and the loan was repaid, resulting in a tax loss for the contributor. The IRS found that the low likelihood that the foreign exchange transactions would result in a profit and the fact that the loan premium was matched to the loss amount meant the transactions should be treated as tax shelters within the meaning of section 6662(d)(2)(C)(ii).

Similarly, in *Sala*,[59] the taxpayer entered into a transaction involving offsetting long and short options. The taxpayer had contributed the options to a partnership and claimed that only the long options should be taken into account in establishing basis in the partnership because the short options were contingent liabilities. The district court initially allowed the taxpayer to claim the tax benefits from the transaction, but the Tenth Circuit reversed the decision and held that the transaction lacked objective economic substance. The appeals court disallowed losses arising from the higher basis that the taxpayer claimed on liquidation of the partnership. It found that the expected tax benefit of nearly $24 million exceeded the potential profit of $500,000 over the course of one year. The Tenth Circuit held that the existence of some potential profit is insufficient to impute substance into an otherwise sham transaction when a commonsense examination of the evidence as a whole indicates the transaction lacked economic substance. The

[56] The opinion recites that the profit paid to the taxpayer was significantly below the economic profit on the position. The court found that the lack of investigation as to why the taxpayer received only a portion of the profit inherent in the termination value of the options was further proof that the transaction lacked economic substance.

[57] *Alpha I LP v. United States*, 93 Fed. Cl. 280 (2010).

[58] *Shasta Strategic Investment Fund LLC v. United States*, 114 AFTR2d 2014-5571 (N.D. Cal. 2014).

[59] *Sala v. United States*, 613 F.3d 1249 (10th Cir. 2010), *rev'g* 552 F. Supp. 2d 1167 (D. Colo. 2008).

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appeals court rejected the district court's findings to the extent that they were based on the consideration of the option program as a whole, holding that only the loss-generating phase is relevant to the economic substance analysis.

In *Jade Trading*,[60] a taxpayer entered into economically offsetting positions in a currency option spread transaction. The taxpayer then contributed its position to a partnership, which later liquidated the taxpayer's interest. The taxpayer claimed a loss of almost $15 million on the grounds that the short option position was not a liability for purposes of section 752. These steps again met the literal requirements of the code.

The Court of Federal Claims held that the transaction was an economic sham and should be disregarded for lacking economic substance, concluding that the options could not be treated as separate transactions because they were "inextricably linked." The court reasoned that had the positions been legally distinct, the counterparty would have required payment of the full face amount of the $15 million premium for the long option and would have required margin collateral of at least $8 million for the short option. Instead, the premiums were netted and the actual payment for the positions was $150,000. The claims court's holding that the transactions lacked economic substance was affirmed by the Federal Circuit.

In *Gold*,[61] the taxpayer was an attorney with no financial experience. The Cantor Fitzgerald brokerage firm recommended a series of transactions to him. First, with a $5,000 deposit to a brokerage account with Gibraltar Financial Corporation, the taxpayer executed a short sale of $2 million of Treasury securities due in nine months. The short sale proceeds purportedly were invested in New York City Housing Authority notes. He pledged the municipal securities to secure his obligations under the short sale. In fact, however, no Treasuries were sold short, and the municipal securities were actually owned by another Gibraltar customer. The transactions were mere bookkeeping entries. Although the taxpayer contributed only $5,000 to the account (and he ultimately recovered $946.63), he reported a net loss of $20,390.59 on the short sale. On these facts, the Tax Court held that "the 'short sale' of the Treasury notes and the 'purchase' of the Housing Authority notes were interrelated component parts of a sham." Accordingly, the deductions were disallowed.

In *Hart*,[62] the taxpayer incurred substantial amounts of capital losses over a three-year period. In each of those years, he short-sold stocks of publicly traded corporations, naked, that had declared "sizable dividends." As a result, he was required to make sizable substitute dividends payments. Immediately after the record date for the dividends, the taxpayer bought the stocks and closed the short sales. In general, the taxpayer had gains that were approximately equal to the amount of dividends. He deducted the substitute dividends payments against ordinary income and used his capital losses to shelter the short-term capital gains that were generated through closing the short sales. The taxpayer, through these transactions, synthetically converted his capital losses into ordinary losses that could be used against high-tax income.

The court found that the taxpayer had no profit motive in entering into these transactions. It noted that the limited duration of the short sale, the complete lack of investment research, the failure to post margin or submit financial statements to the brokers, and the fact that the taxpayer paid above-market prices to close the short sales to the brokers who identified the opportunities were all indicative that the sole motivation for the transactions was the reduction of federal income taxes. Given that the taxpayer's "only expectation of gain was the hope of reducing his taxable income," the court denied his deductions for the substitute dividend payments.

In *Sheldon*,[63] the taxpayer purchased 11 short-term Treasury obligations in 1981 with equity of 0.2 percent to 1.35 percent of the face amount of the Treasuries. To finance the remaining portion of the purchase price, it entered into 11 sale-repurchase transactions[64] (sometimes referred to

[60] *Jade Trading*, 80 Fed. Cl. at 50-51.

[61] *Gold v. Commissioner*, 41 T.C. 419 (1963).

[62] *Hart v. Commissioner*, 338 F.2d 410 (2d Cir. 1964), *aff'g per curiam* 41 T.C. 131 (1963).

[63] *Sheldon v. Commissioner*, 94 T.C. 738 (1990).

[64] A repo is a form of financing.

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as repos) regarding the Treasuries that either were in effect until the Treasuries matured or were rolled over to maturity. The taxpayer paid interest on the repos in 1981, which generated over $5.6 million more in interest deductions in that year than interest income on the Treasuries (which was recognized in 1982). All but one of the sale-repurchase transactions were with the same broker that sold the Treasuries to the taxpayer. Although the taxpayer could have earned a profit if its cost of funds in the sale-repurchase transaction exceeded the yield on the Treasuries, the taxpayer locked in losses on each of the repos to maturity. To sustain the benefit for more than one year, this pattern was repeated in 1982.

The Tax Court found that the purchase and repo financings were not shams in fact. In contrast to *Gold*, the court found that the size of the transactions was customary in the market; that even though a loss was locked in from inception, that did not mean the transactions did not occur; the margin was customary for the securities involved; and the fact that the taxpayer did not take physical delivery was not evidence that the trades were bogus. Nonetheless, the court denied the interest deductions because the "repos to maturity bore higher rates than the yields on the corresponding T-Bills [Treasuries] *without affording [the taxpayer] any potential for future profit*" (emphasis in original).[65] The court found that the "locked-in losses in the transactions with no potential for any profit" was evidence that "the sole objective was to obtain the interest deduction."[66] The taxpayer offered nontax reasons for why it rolled into new repos, rather than simply selling the Treasuries, when initial repos that were not to maturity closed. The court found those explanations unpersuasive.

The taxpayer in *Sheldon* noted that if the Treasuries had appreciated substantially, it could have terminated the repo financings and sold the Treasuries at a net gain. The court responded:

> The potential for "gain" here, however, is not the *sole* standard by which we judge, and in any event is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions. Moreover, there was insufficient potential in any gain to offset the losses locked in for the 1981 transactions.[67]

In light of the highly tax-motivated nature of the transactions and the fact that losses were locked in, the court sustained the negligence penalty.[68]

In TAM 9333006, the IRS denied deductions for dividend equivalent payments made by a borrower of stocks used in naked short sales on the grounds that the transactions lacked a significant pretax profit objective. The corporate taxpayer executed a so-called dividend roll strategy as a cash management technique.[69] Similar to the taxpayer in *Hart*, a corporate taxpayer short-sold stocks 56 times in a single year. These transactions generated $3 million of dividend income and $1.7 million of short-term capital gains on the income side. On the expense side, they generated $2.3 million of dividend equivalent payments and $2.4 million of short-term capital losses on long positions, leaving an economic profit of $11,216. The taxpayer claimed dividends received deductions (DRDs) for the dividends, deducted the dividend equivalent payments in full, and netted most of the capital losses against the capital gains. (The excess capital losses occurred as a result of a sale unrelated to the dividend roll program.) The IRS noted that the taxpayer did not research any of the shorted stocks, that the transactions were not undertaken

[65] *Sheldon*, 94 T.C. at 763.

[66] *Id*. at 768.

[67] *Id*. at 769.

[68] *See also Knetsch v. United States*, 364 U.S. 361 (1960). The analysis in *Sheldon* has frequently been applied in decisions denying deductions for interest generated by sham economic transactions. *United States v. Wexler*, 31 F.3d 117, 124 (3d Cir. 1994); *ACM Partnership. v. Commissioner*, 157 F.3d 231, 258 (3d Cir. 1998); *Saba Partnership v. Commissioner*, T.C. Memo. 1999-359. The court in *Wexler* relied on *Sheldon* to find that interest payments arising from repo-to-maturity transactions were not deductible as genuine indebtedness because the transactions were designed to pay out more in market interest than they received in coupon interest and thus had no purpose apart from their anticipated tax consequences. The court in *ACM Partnership* referred to *Sheldon* in finding that because ACM expected interest rates to decline, which would render its transactions unprofitable, there was no support for a finding that the transactions were designed to serve a nontax motive. Similarly, the court in *Saba Partnership* cited *Sheldon* for the proposition that, despite an expectation of modest profits, which would have been inconsequential compared with expected capital losses, the partnership's transactions, based on unlikely interest rate predictions, did not possess economic substance apart from their anticipated tax consequences.

[69] Law changes enacted in 1984 effectively closed down this strategy for years after 1984. *See* section 263(h).

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with the objective of earning an economic profit, that the short sales were left open for a very short time (70 percent were open for less than 25 days), and that "there was only a short time during which there was market risk."

The IRS's position in TAM 9333006 was rejected, however, in *Duke Energy*.[70] In that case, the district court disagreed with the IRS's contention that the investment program of Duke Energy Corp. constituted a sham. The investment program consisted of purchasing certain preferred stocks and selling short other preferred stocks. Because preferred stocks are fixed income securities and are typically priced according to the market rate of interest for similar securities, the long and short positions established by the investment program were expected to have a high negative correlation. None of the purchased stocks were in the same industry as the stocks sold short. Thus, market risk on the long and short positions, while minimized, was not eliminated.

To borrow shares to sell short, Duke was required to post cash collateral with the dealer from which the securities were borrowed. This collateral earned rebate interest of between 2 and 3 percent per annum for Duke. The securities loan required Duke to make dividend equivalent payments, which were fully deductible for tax purposes. Moreover, Duke was entitled to the DRD on dividends received on its long positions in the investment program.[71] The IRS sought to deny Duke's DRDs and required the capitalization of the dividend equivalent payments made by Duke on the grounds that (1) the investment program was an economic sham with no possibility of real economic gain outside of tax benefits, (2) the investment program as a whole did not have economic substance, and (3) the DRD requirements were not met. The government also argued that the short interest rebates should not be considered in performing a profitability analysis.

The district court ruled that the investment program was not a sham, finding that Duke reasonably expected to earn a pretax profit on the transactions, that Duke was motivated by that expectation, and that Duke actually earned a pretax profit. In reaching this conclusion, the court disagreed with the IRS's argument that the profit analysis should be performed without regard to the short interest rebates. The court said, "To piecemeal out the various income components and then argue that the remaining parts would not comprise a valid business purpose for making the investment is to ignore the holistic approach to the program described" by Duke.[72] Although the return on the short interest rebate of 2 to 3 percent was below the yield available on Treasury instruments at the time, the court said that it constituted a not insignificant amount given the low overall risk of Duke's investment portfolio. In the end, the court found that the short interest rebate together with all the other aspects of the investment program constituted a valid business purpose for entering into the investment program. As such, the court found that this investment was not a sham designed solely to garner tax benefits.

In Notice 98-5, 1998-1 C.B. 334, the IRS sought to deny tax benefits associated with transactions that generated foreign tax credits through an objective approach to calculating expected economic profit and credits and then comparing the economic profit with the credits to determine whether the FTCs would be disallowed. Under this approach, FTCs would be allowed only if the economics of the transaction in relation to the FTCs were substantial. That approach was rejected by the courts in *IES*[73] and *Compaq*.[74] Then, in 2004, the IRS unilaterally revoked Notice 98-5.[75] In the revocation, the IRS listed other tools at its disposal to challenge the FTC-generating transactions that it found abusive, but it withdrew its assertion that the comparison of tax benefits with economic return was a proper interpretation of the federal income tax law. Accordingly, the law as developed by the cases discussed above

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[70] *Duke Energy Corp. v. United States*, 49 F. Supp. 2d 837 (W.D.N.C. 1999). Specifically, the IRS introduced testimony that the gains and losses earned in connection with these transactions were too small to have economic substance, but the court rejected that argument.

[71] Each purchase and sale of preferred stock was timed to meet the requirements under section 246(c)(1).

[72] *Duke Energy*, 49 F. Supp. 2d at 843.

[73] *IES Industries Inc. v. United States*, 84 AFTR2d 99-6445 (N.D. Iowa 1999), *rev'd*, 253 F.3d 350 (8th Cir. 2001).

[74] *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999), *rev'd*, 277 F.3d 778 (5th Cir. 2001).

[75] Notice 2004-19, 2004-1 C.B. 606.

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(and others) remains the law on economic substance: The transaction must have reasonable pretax economics in order to be respected, but it is not the law that the pretax economics of a transaction must be at least a certain percentage of the overall expected return for a transaction to be respected for federal income tax purposes.

In *Blum*,[76] the taxpayer paid KPMG at least $687,500 to enter into an offshore portfolio investment strategy (OPIS) transaction. The taxpayer had founded Buy.com in 1997. In 1998 the taxpayer sold a minority interest in the company for a total of $45 million, all of which constituted a capital gain. In accordance with the OPIS transaction, the taxpayer paid approximately $1.5 million and claimed that the OPIS transaction yielded over $45 million in capital losses to offset his 1998 Buy.com capital gain. The Tax Court held that while KPMG painstakingly structured an elaborate transaction with extensive citations to complex federal tax provisions, the OPIS transaction lacked economic substance. In so holding, the Tax Court looked to the standard set by the Tenth Circuit, which it described as applying a "unitary analysis" in which both the taxpayer's subjective business motivation and the objective economic substance of the transactions are considered. The presence of some profit potential does not necessitate a finding that the transaction has economic substance. Instead, the Tenth Circuit requires that tax advantages be linked to actual losses. According to the Tax Court, the Tenth Circuit has further reasoned that "correlation of losses to tax needs coupled with a general indifference to, or absence of, economic profits may reflect a lack of economic substance."[77]

Applying those standards, the Tax Court held that the taxpayer's OPIS transaction lacked economic substance. The court considered the following factors: (1) the OPIS transaction consisted of prearranged steps to generate a loss; (2) the taxpayer did not approach the transaction as an investor; (3) the loss had no economic reality; (4) the losses dwarfed any profit potential; and (5) the numbers proposed by taxpayer's expert did not add up.[78]

The IRS could seek to use the son-of-BOSS and BLIPS cases to argue that the distribution of the appreciated single stock option positions, coupled with the recognition of loss on the remaining positions, lacks economic substance. As in *K2 Trading*, the option positions in the aggregate do not appear to allow BOXX to recognize any gain or loss because any potential gain or loss on one set of options is matched by loss or gain on the other pair.

The redemption transaction then allows BOXX to recognize a loss that is not matched by any gain recognition. In *K2 Trading*, *Palm Canyon X*, and *Alpha I*, the court disallowed noneconomic losses generated by the fact that the tax law separated the two legs of a riskless transaction.

The IRS could assert that the holding of *Alpha I* gives it the right to challenge BOXX's recognition of a loss on the retained single stock option positions. In *Alpha I*, the taxpayers held highly appreciated stock. They then executed a short sale of Treasury securities. They assigned the stock and the short sale proceeds, subject to the obligation to close the short sale, to a partnership. The partners did not reduce their basis in the partnership interest by the short sale obligation. The partnership closed out the short sale and then liquidated. In the liquidation of the partnership, the partners substituted their overstated outside basis to the appreciated stock, which eliminated the tax gain inherent in the stock. The stock was then sold or contributed to a charity.

The court's two-factor test — that is, whether the transaction had economic substance beyond its tax benefits and whether there were nontax reasons for undertaking the transaction, supported disallowing the loss. It is possible to argue that the overstated basis that results from the liquidation of the partnership is akin to ability to make a tax-free distribution of the appreciated single stock option positions (assuming that there is no business purpose for the single stock option positions). If, in fact, BOXX has executed the single stock option transactions in a manner that doesn't allow it the opportunity to earn a

[76] *Blum v. Commissioner*, T.C. Memo. 2012-16, *aff'd*, 737 F.3d 1303 (10th Cir. 2013).

[77] *Id.*

[78] *Id.*

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substantial pretax profit, its ability to claim a loss on the retained single stock options could be vulnerable under this test.

The IRS could also assert that the single stock option transactions and distribution of the appreciated positions are "inextricably linked" as in *Jade Trading* and *Sala*. If BOXX has been using the single stock option transactions to generate losses to shelter the gains from the box option transactions with the ready assistance of its authorized participant, this fact could be used to support a challenge that the losses are not economic.

Finally, the IRS could use the *Hart* decision to assert that BOXX is synthetically converting the gains on the box options into tax-free income. In *Hart*, the taxpayer used low-risk transactions to generate capital gains to use stranded capital losses. The IRS was successful in asserting that the only motivation for the short sales was to convert ordinary income to capital gains to use the capital losses. The IRS could assert that the use of section 852(b)(6) to absorb gains on the single stock options is being used to shelter the gains on the box option transactions.

If the IRS made any of these assertions, BOXX certainly has the counterargument that the separation of the long and short single stock option positions creates the opportunity for it to recognize income or mitigate loss on the retained positions. Moreover, BOXX is not overstating basis in any position. After the profit positions have been separated from the loss legs of the trade, there is a true economic loss that BOXX should be entitled to claim.

IX. Conclusion

Creation-redemption transactions have been common for quite some time. What makes BOXX unique is the fact that it has recognized that a debtlike return can be earned on positions that treat those returns as capital gains and that it can shelter the returns with a riskless straddle transaction unrelated to its investment thesis. Conceptually, there is no reason why equity-investing RICs couldn't use the single stock option strategy to shelter their recognized capital gains as well. While the strategy has some tax uncertainty, it appears strong enough to be offered to investors with adequate disclosure of the risks. ■

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