

# JOURNAL OF ACCOUNTANCY

TAX MATTERS

## Parent corporation's options treated as positions held by subsidiaries

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AUGUST 2013

In a Field Attorney Advice (FAA) memo, the IRS Office of Chief Counsel (OCC) advised that a parent corporation's S&P 500 options held to hedge against price fluctuations of the equity portfolio held by four related subsidiaries should be treated as positions held by the subsidiaries. Consequently, the holding period of the subsidiaries' equity portfolio was limited under Sec. 246(c)(4)(C), and a portion of the parent's dividend-received deduction attributable to those equities should be denied.

Sec. 243(a) provides for a dividend-received deduction to corporations that receive dividends from other domestic corporations. To qualify for the deduction, the dividend-paying stock must be held for more than 45 days during the 91-day period surrounding the ex-dividend date. Sec. 246(c)(4)(C) reduces a taxpayer's holding period of stock for purposes of the dividend-received deduction where a taxpayer diminishes its risk of loss by holding one or more positions with respect to substantially similar or related property. Regs. Sec. 1.246-5(b)(2) identifies risk as being diminished where changes in the fair market value of stock and positions held in similar or related property are reasonably expected to vary inversely. Regs. Sec. 1.246-5(c)(6) treats property held by related parties as property held by the taxpayer if the taxpayer intends to avoid the holding period requirement of Sec. 246 or the straddle rules of Sec. 1092. Under Regs. Sec. 1.1092(d)-2, an offsetting position in a stock index or option on a stock index is substantially similar or related property with respect to stock if the performance of the index mimics the performance of the stock.

In the FAA, the parent corporation and its four wholly owned subsidiaries were part of an affiliated group that filed consolidated tax returns. During 2011, the group received dividends from corporations against which the parent had purchased S&P 500 index options to hedge against stock price fluctuations in the equity portfolio of the subsidiaries. The parent knew when entering the option positions that the property being hedged was that of the subsidiaries' equity portfolio.

On its 2011 tax return, the parent reported a dividend-received deduction that related in part to dividends received from corporations on which the parent had purchased S&P 500 index options. The IRS Exam team sought to limit this portion of the parent's dividend-received deduction by application of Sec. 246(c)(4)(C).

The parent conceded that the options were substantially similar or related property that diminished the risk of loss with respect to the equity portfolio of the subsidiaries. However, the parent claimed that it did not hold the positions to avoid the application of Sec. 246 or Regs. Sec. 1.1092(d)-2, so the positions should not be treated as positions held by the subsidiaries.

The OCC concluded that the parent's options on the S&P index should be treated as positions held by the subsidiaries. The OCC found that upon entering the options the parent knew that the positions offset the equity portfolio of the subsidiaries and, in fact, entered into the option strategy to offset the risk of loss in the subsidiaries' equity portfolio. The OCC said that this showed that the positions were held to avoid application of Sec. 246(c)(4)(C), even if the parent had other business reasons for hedging the assets of its subsidiaries in this manner. Thus, OCC advised that the holding period of the subsidiaries' equity portfolio was limited by Sec. 246(c)(4)(C), and a corresponding portion of the parent's dividend-received deduction should be denied.

■ FAA 20131902F (5/10/13)

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