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SIH Partners: Tax Court Applies Anti-Abuse Rule to 70/30 Basket Hedge Structure

A recent decision demonstrates that satisfying the mechanical 70/30 overlap test alone is insufficient to protect a basket hedge where the transaction's economics indicate that its principal purpose was tax savings.

On August 6, 2026, the U.S. Tax Court issued its opinion in *SIH Partners LLP v. Commissioner*, 167 T.C. No. 8. At issue was a portfolio swap that, on its face, satisfied the well established "70/30" mechanical test used to hedge appreciated stock positions. The Court nonetheless concluded that the transaction violated the anti-abuse rule contained within the same regulation, and accordingly denied the taxpayer qualified dividend income (QDI) treatment and the associated foreign tax credits.

The Governing Rules

Dividends generally qualify for reduced tax rates under Section 1(h)(11), and withholding taxes on those dividends can generate foreign tax credits under Section 901(k). Both benefits, however, are conditioned on satisfying minimum holding period requirements. Both provisions incorporate the holding period rules of Section 246(c), which exclude any period during which a taxpayer's risk of loss on a stock was diminished by holding "substantially similar or related property."

Treasury regulations under Section 1.246-5 define that phrase for basket style hedges. A short position referencing 20 or more unrelated issuers is treated as a "portfolio position," and such a basket is considered substantially similar or related to a taxpayer's long stock only where substantial overlap exists between the two. The regulation establishes a bright line, mechanical threshold for that overlap of 70%.

This mechanical test has long supported a common structure: hedging an appreciated stock by shorting a basket in which the appreciated name constitutes less than 70% of the basket's value, with the remainder composed of unrelated names. Where the appreciated name falls below that 70% threshold, the basket is treated as a single "portfolio position" rather than disaggregated into

individual single-stock shorts, subject only to a backstop anti-abuse rule that market participants have generally understood to apply narrowly.

That anti-abuse rule nonetheless treats a multi-stock position as substantially similar or related property where (1) the position is reasonably expected to virtually track the taxpayer's long stock, whether directly or inversely, and (2) the position is part of a plan whose principal purpose is to generate tax savings that significantly exceed the plan's expected pre-tax profit.

The Transaction at Issue

SIH Partners, an affiliate of Susquehanna International Group, held long positions in four Swiss companies, Nestlé, Novartis, Roche, and Swisscom, across their respective dividend record dates. Concurrently, the taxpayer offset its exposure to those same four stocks through a portfolio swap with Morgan Stanley.

This swap was not a standalone hedge constructed solely for the Swiss positions. It was incorporated into a pre-existing, firmwide basket of broad market index shorts that SIH maintained for general risk management purposes. The addition of the market index shorts reduced the Swiss names to approximately 64% of the basket's total value, below the 70% mechanical threshold. Notwithstanding this dilution, the short position in each individual Swiss stock was sized to fully offset the corresponding long position.

For the 2012 tax year, SIH treated approximately \$170.8 million of dividends from these positions as qualified dividend income and claimed approximately \$25.6 million in associated foreign tax credits, while remitting approximately \$130.2 million in substitute dividend payments to Morgan Stanley under the swap. The composition of the swap was not static; SIH adjusted it more than 200 times during the year, with a significant number of these adjustments timed to coincide with the Swiss dividend dates, thereby preserving the offset between the long and short positions.

How the Court Ruled

The Internal Revenue Service's principal argument, that the swap should be treated as a series of separate single-stock short positions under a substance over form theory, was rejected by the Court. The Court concluded that the transaction constituted a genuine portfolio swap, both in form and in substance, and observed that the applicable regulations expressly contemplate that a basket's composition will change over time.

The Court further agreed that the mechanical 70% test had been satisfied. At approximately 64% overlap, the Swiss stocks fell below the threshold, and the basket accordingly qualified for the portfolio exception on its face.

The anti-abuse rule produced a different result. In applying the virtual tracking prong, the Court did not evaluate the swap in its entirety against SIH's Swiss holdings. Instead, it examined the individual components of the basket, specifically the Swiss stock legs, and determined that those legs, considered in isolation, constituted an exact offset to SIH's long positions and therefore did virtually track them.

With respect to the second prong, the Court found that SIH's own contemporaneous projections reflected expected pre-tax profit of no more than approximately \$2.4 million, a figure substantially exceeded by tax savings in excess of \$25 million. The Court concluded that this disparity satisfied the anti-abuse rule's principal purpose requirement, without making an explicit finding regarding SIH's subjective intent. The magnitude of the disparity between the tax benefit and the expected pre-tax profit was determinative.

Having concluded that both prongs of the anti-abuse rule were satisfied, the Court held that the Swiss stock holdings constituted substantially similar or related property. This holding shortened SIH's holding period for the relevant shares, thereby defeating both QDI treatment under Section 1(h)(11) and the foreign tax credits claimed under Section 901(k).

Why This Matters Beyond the Four Corners of the Case

The most consequential aspect of this opinion is the Court's component level application of the virtual tracking test. Rather than assessing whether the basket as a whole tracked the taxpayer's stock, the Court assessed whether any individual component of the basket did so, and applied that narrower analysis to reach a result the mechanical test was designed to preclude.

This reading is textually contestable. The regulation's anti-abuse language refers to changes in value of "the position or the stocks reflected in the position," and a reasonable argument exists that this language refers to the basket in its entirety rather than to a selected subset of its constituent names. Under the Court's approach, however, a basket may fail the anti-abuse test even where the remaining 30% or more of the basket carries genuine, independent market risk that would ordinarily preclude the position as a whole from tracking the appreciated stock.

As a practical matter, the mechanical 70/30 safe harbor remains available, but its protective scope has narrowed considerably, particularly for structures in which the anticipated tax benefit clearly exceeds the anticipated economic return. A basket constructed around a precise single-name offset is now considerably more susceptible to disaggregation by the Service, even where that offset is embedded within a larger, diversified position.

The Court did not adopt a categorical rule that all 70/30 baskets fail the anti-abuse test. Both prongs must still be satisfied, which preserves room for taxpayers able to demonstrate a genuine investment, financing, or hedging rationale, and for structures that retain meaningful basis risk rather than a precise, dollar-for-dollar offset. A basket rebalanced less frequently may also be better positioned, although the opinion does not confine its reasoning to actively managed positions coordinated with dividend dates.

Implications Beyond QDI and Foreign Tax Credits

The direct issues in *SIH Partners* concerned qualified dividend treatment, the dividends received deduction, and foreign tax credits. The Section 1.246-5 definition of "substantially similar or related property," however, is not confined to this context. It is cross-referenced elsewhere in the Internal Revenue Code, and the Court's reasoning may extend to those provisions as well.

The stock straddle rules under Section 1.1092(d)-2 incorporate the same definition, raising the possibility that a basket previously treated as a single, undifferentiated position could be

recharacterized as creating a straddle, with attendant risk of suspended holding periods and deferred loss recognition.

The application of this reasoning to constructive sale planning under Section 1259 presents a closer question, as that provision does not fully incorporate Section 1.246-5 into its own analytical framework, and the Court did not decide whether a 70/30 basket constitutes an offsetting notional principal contract for constructive sale purposes. Nonetheless, market participants have historically relied on the same regulatory framework, related cure provisions, and legislative history to support basket opacity in the constructive sale context, and the Court's willingness to examine the components of an otherwise compliant basket may undermine that position. Comparable reasoning could eventually be advanced in the wash sale context as well.

Bottom Line

SIH Partners does not eliminate the viability of the 70/30 basket hedge. It confirms, however, that the Service and the courts retain the authority to look beyond a mechanically compliant structure and disaggregate it to the individual stock level where a hedge produces precise, single-name offsetting exposure and the anticipated tax benefit substantially exceeds the anticipated economic profit. Pending further clarification, narrowing, or appellate review, taxpayers and their advisors should treat bespoke baskets constructed primarily to hedge a single appreciated position, particularly where tax deferral is the principal objective and anticipated pre-tax profit is minimal, as presenting materially greater risk than the mechanical test alone would suggest.



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