Prepaid Forward Contracts: What’s All the Fuss?

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There has been significant discussion over the last five years of prepaid forward contracts and various other transactions and instruments that are similar. Some recent discussions have been prompted (or at least punctuated) by Anschutz Co., 2011 U.S. App. LEXIS 25865 (10th Cir. 2011), recently decided by the Tenth Circuit Court of Appeals. If you have read descriptions of these transactions in the popular press or otherwise and are confused, you are not alone.

The circumstances under which these contracts are executed vary. A prepaid forward contract may involve the sale of stock or other assets. One increasingly common scenario involves the assignment of all or a portion of a legal claim in a lawsuit. In any of these situations, the question is how contract payments are taxed.

**Defined**

A “traditional forward contract” has been defined as an executory contract pursuant to which the buyer agrees to purchase from the seller a fixed quantity of property at a fixed price, with payment and delivery to occur on a fixed future date. [See Joint Committee on Taxation, Present Law and Analysis Relating to the Tax Treatment of Derivatives (JCX-21-08), Mar. 4, 2008, at 6–7.] This definition bears repeating; it suggests these are actually simple arrangements in concept.

In practice, of course, they are often anything but. A “prepaid” forward requires the buyer to pay the seller the forward price (discounted to present value on the date of payment) at the time the parties enter into the contract (as opposed to the delivery date). The tax goal is simple.

A taxpayer owning property hopes to defer the incidence of taxation until it is clear what he will receive and until he will receive it. This seems reasonable. The taxpayer who enters into a forward contract with respect to the property is generally not treated as having sold the property when entering into the contract. [See Lucas v. North Tex. Lumber, SCt, 2 USCT ¶484, 281 US 11 (1930).]

Thus, a forward contract appears to constitute an open transaction, similar to an option, until it is sold, exchanged, settled or allowed to lapse. [See, e.g., Virginia Iron Coal & Coke Co., 37 BTA 195, Dec. 9930 (1938), aff’d, CA-4, 38-2 USCT ¶9572, 99 F2d 919 (1938), cert. denied, 307 US 630 (1938); see also JCX-21-08. This is key, suggesting that like a loan, money may change hands but there is no immediate taxable event. The rationale for this favorable treatment is also simple.

Until the transaction closes, it is impossible to determine how the advance payments should be reported. In fact, it is impossible to determine whether the payments even constitute taxable income. [Virginia Iron Coal & Coke Co., supra, 37 BTA 195, at 198.] Accordingly, the advance payment in a forward contract could be considered equivalent to a deposit.

A deposit has no immediate tax consequences. Rev. Rul. 58-234, 1958-1 CB 279, and Rev. Rul. 78-182, 1978-1 CB 265, hold that no income is derived from the receipt of either a “put” or “call” option premium unless and until the option expires or is exercised or terminated.

**Rev. Rul. 2003-7**

In Rev. Rul. 2003-7, IRB 2003-5, 1, the IRS approved open transaction treatment for a variable prepaid forward contract. In that ruling, the IRS held that no current sale occurred when a shareholder: (1) received a fixed amount of cash; (2) simultaneously entered into an agreement to deliver on a future date a number of shares of common stock that varied significantly depending on the value of the shares on the delivery date; (3) pledged the maximum number of shares for which delivery could be required under the agreement; (4) had the unrestricted legal right to deliver the pledged shares or to substitute cash or other shares for the pledged shares on the delivery date; and (5) was not economically compelled to deliver the pledged shares.

The importance of this ruling cannot be overstated. No current sale occurred even though the shareholder intended to deliver the pledged shares at settlement in order to satisfy the shareholder’s obligations under the agreement. Significantly, the IRS also ruled there...
was no constructive sale of stock under Internal Revenue Code Section (“Code Sec.”) 1259.

Because the number of shares to be delivered under the agreement was subject to significant variation, the agreement was not a contract to deliver a substantially fixed amount of property for purposes of Code Sec. 1259(d)(1). As a result, the agreement did not meet the definition of a forward contract under Code Sec. 1259(d)(1). Therefore, it did not cause a constructive sale under Code Sec. 1259(c)(1)(C).

The Philip Anschutz Story
Much of the current discussion of prepaid forward contracts emanates from the decisions of the Tax Court and Tenth Circuit. They recently held a prepaid forward sale of stock, coupled with a loan of that stock to the forward purchaser, triggered a taxable sale of the stock upon receipt of the up-front cash payments. [Anschutz Co., 135 TC 78, Dec. 58,275 (2010), aff’d, supra.] In Anschutz, the court found the transaction unlike that in Rev. Rul. 2003-7.

To the Tax Court and Tenth Circuit, the Anschutz transaction, taken as a whole, immediately transferred the benefits and burdens of ownership to the forward purchaser. These benefits and burdens included:

1) legal title to the shares;
2) all risk of loss;
3) a major portion of the opportunity for gain;
4) the right to vote the stock; and
5) possession of the stock.

Consequently, open transaction treatment was inappropriate.

Many may now seek to distinguish their fact patterns from that in Anschutz. Indeed, many taxpayers may be riveting their attention on Rev. Rul. 2003-7, which (it is worth underscoring) the IRS has not withdrawn or modified.

Yet it seems plain that the law governing prepaid forward contracts is in flux. In Notice 2008-2, IRB 2008-2, 252, the IRS requested (and received) comments from the public on the tax treatment of prepaid forwards. Guidance has yet to be issued.

In Rev. Rul. 2008-1, IRB 2008-2, 248, a foreign-currency linked transaction that resembled a prepaid forward contract was taxed as a foreign-currency denominated debt instrument. IRS officials have suggested that this ruling has little bearing on prepaid forward contracts that do not involve the specific foreign-currency rules of Code Sec. 988. [See comments of Jeffrey Dorfman, chief of Branch 5, IRS Office of Associate Chief Counsel (International), quoted in 2008 TNT 35-2 (Feb. 21, 2008).]

No Current Taxation
When the prepaid amount is tendered under a prepaid forward contract that emulates Rev. Rul. 2003-7, the taxpayer should not have an immediate taxable event. The prepaid amount should not be gross income upon receipt because it cannot yet be determined what it is. That should be the case in a forward sale of a legal claim involving:

1) the receipt of an up-front cash payment;
2) an agreement to deliver a portion of the claim that varies significantly depending on its value at the contract’s expiration date;
3) a pledge of the entire claim;
4) the right to deliver either cash or a portion of the pledged claim upon settlement; and
5) no apparent economic or legal compulsion to deliver the claim itself rather than cash.

Gain or Loss upon Settlement
Of course, there are income tax consequences once the open transaction closes. The IRS generally views the physical settlement and the cash settlement of a forward contract as economically identical. Settlement of a forward contract should be treated for tax purposes in the same manner as a sale of the underlying asset. [See LTR 200450016 (Aug. 17, 2004), LTR 200518062 (Jan. 31, 2005) and CCA 201025047 (Mar. 22, 2010).] The gain or loss realized by a party to a forward contract appears to be governed by the general rules applicable to the sale or disposition of the underlying asset.

Example
Seller S enters into a prepaid forward contract with respect to stock, receiving $100 as an advance payment. At settlement, S must deliver shares of stock according to a variable formula or an equivalent value in cash. If S physically delivers stock on settlement, S will recognize gain or loss based on the difference between $100 and the basis in the stock S delivers. If S delivers cash, S’s gain or loss is based on the difference between $100 and the payment made to settle the contract.
The buyer’s perspective is the mirror image of the seller’s. Upon making the $100 payment, Buyer B takes a $100 basis in the forward contract. If B sells the contract, B will recognize gain or loss based on the difference between the amount realized and his $100 basis.

If the forward is physically settled, B has no realization event and receives the stock with a $100 basis. If the forward is cash settled, B recognizes gain or loss based on the difference between the cash payment received and his $100 basis.

**Settling in Cash or Property**

In LTR 200450016, the IRS ruled that the gain resulting from a corporation’s receipt of property in a cash settlement of a forward contract to sell its own stock is not recognized under the principles of Code Sec. 1032. Code Sec. 1032(a) provides that a corporation does not recognize gain or loss on the receipt of money or property in exchange for its own stock. The IRS reasoned that the cash settlement of a forward contract should be treated for tax purposes in the same manner as a sale of the underlying stock.

After all, the corporation has the same economic gain or loss regardless of whether it issues the stock for the payment or receives a cash settlement in lieu of issuing stock. In a cash settlement, the corporation is effectively deemed to issue its stock at the forward contract price, and immediately buy it back from the counterparty at the fair market value. Because the corporation would recognize no gain or loss if it sold its stock directly, no gain or loss should be recognized upon a cash settlement of a forward contract with respect to that stock. [See CCA 201025047, supra.]

**Conclusion**

Prepaid forward contracts will probably always be regarded as somewhat exotic. At the same time, they can clearly be legitimate means of generating cash in a tax-efficient and financially savvy way. However, particularly after the decision in Anschutz Co., there will be a greater degree of uncertainty surrounding them.