

Prepaid Forward Contracts Aren't All Bad

By Robert W. Wood



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<http://www.taxinstitute.com>. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Prepaid forward contracts may seem like smoke and mirrors, especially if they are complex and result in monies that are almost indistinguishable from sales proceeds but somehow are treated differently. That view may be especially tempting in light of the government victory in *Anschutz Co. v. Commissioner*. However, many forward contracts are legitimate, respected, and entitled to favorable tax treatment, as Wood explains.

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There is significant discussion these days of prepaid forward contracts and various other transactions and instruments that are more or less similar. Some renewed considerations have been prompted by *Anschutz Co. v. Commissioner*, recently decided by the Tenth Circuit.¹ If you have read descriptions of these transactions in the popular press or elsewhere 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 in-

¹*Anschutz Co. v. Commissioner*, 664 F.3d 313 (10th Cir. 2011), Doc 2011-27117, 2011 TNT 249-4, *aff'd* 135 T.C. 78 (2010), Doc 2010-16342, 2010 TNT 141-13.

creasingly common scenario involves the assignment of all or a portion of a legal claim in a lawsuit. In any of these situations, the primary question is how contract payments are taxed.

Defined

A traditional forward contract has been defined as an executory contract under which the buyer agrees to purchase a fixed quantity of property at a fixed price, with payment and delivery to occur on a fixed future date.² This definition bears repeating as it suggests these are simple arrangements in concept.

In practice, of course, a prepaid forward contract owner is often anything but simple. It 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 on the delivery date). The tax goal is simple. A taxpayer owning property who enters into a forward contract regarding that property is generally not treated as having sold the property when entering into the contract.³

Thus, a forward contract appears to constitute an open transaction, similar to an option, until it is sold, exchanged, settled, or allowed to lapse.⁴ This is key, suggesting that as with 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, or whether the payments even constitute taxable income.⁵ Accordingly, the advance payment in a forward contract could be considered equivalent to a deposit, which has no immediate tax consequences. Rev. Rul. 58-234⁶ and Rev. Rul. 78-182⁷ conclude that no income is derived from the

²See Joint Committee on Taxation, "Present Law and Analysis Relating to the Tax Treatment of Derivatives," JCX-21-08 (Mar. 4, 2008), at 6-7, Doc 2008-4664, 2008 TNT 44-15.

³See *Lucas v. N. Tex. Lumber*, 281 U.S. 11 (1930).

⁴See, e.g., *Virginia Iron Coal & Coke Co. v. Commissioner*, 37 B.T.A. 195 (1938), *aff'd*, 99 F.2d 919 (4th Cir. 1938); see also JCX-21-08, *supra* note 2.

⁵*Virginia Iron Coal & Coke Co.*, 37 B.T.A. at 198.

⁶1958-1 C.B. 279.

⁷1978-1 C.B. 265.

receipt of either a put or call option premium unless and until the option is expired, exercised, or terminated.

Rev. Rul. 2003-7

In Rev. Rul. 2003-7,⁸ the IRS approved open transaction treatment for a variable prepaid forward contract, and 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 several 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 to satisfy the shareholder's obligations under the agreement. Significantly, the IRS also ruled there was no constructive sale of stock under section 1259.

Section 1259 provides that in a forward sale of appreciated stock, debt instrument, or partnership interest, a taxpayer recognizes gain if the contract requires the taxpayer to deliver the same or substantially identical property. That effectively would eliminate the tax deferral otherwise available to an open transaction.

In Rev. Rul. 2003-7, however, 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 section 1259(d)(1). As a result, the agreement did not meet the definition of a forward contract under section 1259(d)(1), and did not result in a constructive sale under section 1259(c)(1)(C).

The Philip Anschutz Story

Much of the current discussion of prepaid forward contracts emanates from the Tax Court and Tenth Circuit decisions in *Anschutz*. The courts held that a prepaid forward sale of stock, coupled with a loan of that stock to the forward purchaser, triggered a taxable sale of the stock on receipt of the upfront cash payments. The trial and appellate courts distinguished the transaction in *Anschutz* from that in Rev. Rul. 2003-7. In most respects, this is hardly surprising.

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, both courts found that open transaction treatment was inappropriate.

Some taxpayers who entered into similar share lending arrangements are choosing to settle with the IRS. Once again, that is hardly surprising. Moreover, those who do not settle (probably a greater number) may devote their attentions to attempting to distinguish their fact patterns from *Anschutz*.⁹

Many may be riveting their attention on Rev. Rul. 2003-7, which the IRS has not withdrawn or modified. Yet it seems plain that the law governing prepaid forward contracts is in flux. In Notice 2008-2,¹⁰ the IRS requested (and received) public comments on the tax treatment of prepaid forwards.

Notice 2008-2 announced that the IRS and Treasury were considering whether the parties to one of these transactions should be required to accrue income and expense during the term of the transaction, if the transaction was not otherwise classified as indebtedness for federal income tax purposes. Related issues on the table apparently include:

- The appropriate method for accruing income or expense, if deemed appropriate. Examples mentioned in the notice included a mark-to-market method or a method resembling the non-contingent-bond method set out in reg. section 1.1275-4. The non-contingent-bond method generally involves constructing a projected payment schedule for the debt instrument and applying rules similar to those for accruing original issue discount.
- The appropriate character of any income accruals required under an accrual regime, as well as the character of amounts less than, or in excess of, these accruals.
- Whether the tax treatment of the transactions should vary depending on the nature of the underlying asset (for example, stocks versus commodities).
- Whether the tax treatment of the transactions should vary depending on whether the transactions are: (i) executed on a futures exchange;

⁹See Jeremiah Coder, "More Taxpayers Settling Their Variable Prepaid Forward Contract Cases," *Tax Notes*, Jan. 9, 2012, p. 166, *Doc 2012-9*, or *2012 TNT 2-1*.

¹⁰2008-2 C.B. 252, *Doc 2007-26969*, *2007 TNT 237-10*.

⁸2003-1 C.B. 363, *Doc 2003-1634*, *2003 TNT 12-13*.

or (ii) memorialized in an instrument that is traded on a securities exchange.

- Whether the transactions should be treated as indebtedness under regulations issued under section 7872.
- Whether section 1260 applies, or should apply, to prepaid forward contracts and similar transactions. Under section 1260, long-term capital gains from some constructive ownership transactions can be recharacterized as ordinary income, and an interest charge applies as though the gain had been recognized in prior year.

Contemporaneously with Notice 2008-2, the IRS issued Rev. Rul. 2008-1,¹¹ describing a foreign-currency linked transaction that resembled a prepaid forward contract and was taxed as a foreign-currency denominated debt instrument. At the inception of the contract, the holder delivered the U.S. dollar equivalent of €75.

At maturity three years later, the issuer was required to pay the U.S. dollar equivalent of €75, plus the U.S. dollar value at maturity of a return based on euro interest rates. The IRS noted that, in form, the instrument resembled a U.S. dollar denominated derivative contract under which the holder prepays its obligations and is entitled to receive a return based exclusively on the value of property at maturity. However, IRS officials have suggested in later discussions that this ruling has little bearing on prepaid forward contracts that do not involve the specific foreign currency rules of section 988.¹²

No Current Taxation

Despite Notice 2008-2 and the recent controversy over the Anschutz transactions, the IRS has not withdrawn or modified Rev. Rul. 2003-7. Thus, it appears clear that taxpayers can still rely on the favorable principles of that ruling. 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 on receipt because the nature of the prepaid amount cannot yet be determined. That should be the case in a forward sale of a legal claim involving: (1) the receipt of an upfront 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 on settlement; and (5) no apparent economic or legal compulsion to deliver the claim itself rather than cash.

Gain or Loss on Settlement

Of course, there are income tax consequences once the open transaction closes. The IRS generally views the physical and the cash settlement of a forward contract as economically identical. For tax purposes, settlement of a forward contract should be treated in the same manner as a sale of the underlying asset.¹³

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: A seller (S) enters into a prepaid forward contract regarding 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 at 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. On making the \$100 payment, the 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 contract is physically settled, B has no realization event and receives the stock with a \$100 basis. If the forward contract 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 under section 1032, there is no recognized gain resulting from a corporation's receipt of property as a cash settlement in a forward contract for the sale of stock. Section 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.

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

¹¹2008-1 C.B. 248, *Doc 2007-26968*, 2007 TNT 237-8.

¹²See comments of Jeffrey Dorfman, branch 5 chief, IRS Office of Associate Chief Counsel (International), quoted in Crystal Tandon and Coder, "IRS Still Gathering Input on Prepaid Forward Contracts," *Tax Notes*, Feb. 25, 2008, p. 897.

¹³See LTR 200450016, *Doc 2004-23356*, 2004 TNT 239-54; LTR 200518062, *Doc 2005-9632*, 2005 TNT 88-46; ILM 201025047, *Doc 2010-14164*, 2010 TNT 123-14.

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 on a cash settlement of a forward contract regarding that stock.¹⁴

Conclusion

Prepaid forward contracts will probably always be regarded as somewhat exotic. At the same time, they clearly can be legitimate means of generating cash in a tax-efficient and financially savvy way. Particularly after the *Anschutz* decision, there will be a greater degree of uncertainty surrounding prepaid forward contracts. However, transactions that stick closely to the pattern set out in Rev. Rul. 2003-7 and that do not involve a transfer or loan of the underlying property to the counterparty, should still be on solid ground.

¹⁴See ILM 201025047.

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