Using Prepaid Forward Contracts for Stock and Legal Funding

by Robert W. Wood and Donald P. Board

Robert W. Wood

Donald P. Board

Robert W. Wood is a tax lawyer with Wood LLP and the author of *Taxation of Damage Awards and Settlement Payments*, Fifth Edition, and other books available at www.TaxInstitute.com. Donald P. Board is a partner with Wood LLP.

In this article, Wood and Board examine prepaid forward contracts, which are commonly used in securities sales and litigation funding transactions.

This discussion is not intended as legal advice.

Loan or sale? If you need money, you might think of both. If your uncle, best friend, or bank lends you money to tide you over, is it taxable income? Fortunately, it's not — if it's a real loan. In a personal, business, or family context, loans are not income. But the loan-versus-income distinction lands many taxpayers in trouble. If you receive a payment that you can't quite explain, you might be tempted to call it a loan. After all, it may seem to be the perfect way to put off the inevitable tax hit.

If it's a loan, can you deduct the interest? That can be a tricky question, so a deduction is not always assured. Interest can be large on risky bets such as litigation funding or pre-initial-public-offering stock. Not being able to deduct interest could be painful. As for interest rates, most loans are probably on commercial terms with stated interest, so there shouldn't be questions in those cases. More informal loans may not call for interest, but the IRS can impute it.

Then there is the back end of the loan. When you repay loan principal, it's not deductible. As a corollary, the lender doesn't have income on repayment, except for any interest it receives. But the fact that a payment is really a loan doesn't always mean there is no income later. If a loan is forgiven, it suddenly is income.

That is cancellation of debt income, often shortened to COD. You received cash when you borrowed the money, but when you do not have to repay it, the cash is no longer loan proceeds. Instead, it becomes current income. The tax code generally taxes COD income, treating it like cash paid to you. This unpleasant rule might seem easy to ignore. However, when a loan is forgiven, you'll generally receive a Form 1099-C from the lender reporting income to you — and telling the IRS.

Sale Instead?

If instead of a loan, you opt for a sale, it is taxable. If you receive money for selling your stock, it is taxable. If you receive money for assigning half of your expected lawsuit recovery, it's the same result. However, it is worth asking whether you can split the baby. Can you get money upfront that is not a loan, but that also isn't income, at least not when you receive it? The answer to this riddle is sometimes, with a variable prepaid forward contract.

Forward Sale

Because the transaction is a sale, you might assume that you must report the upfront money (the sale proceeds) immediately as income. However, a sale using a *variable* contract leaves open how much money (stock sale proceeds, litigation case proceeds, etc.) the seller must later deliver to the funder.[1] The amount is uncertain because the formula for computing the amount of the seller's payment generally depends on facts that will not be known until the underlying proceeds come in.

When you sign a prepaid forward contract and receive money, you have entered a contract to sell a portion of your stock sale proceeds or lawsuit recovery *later*. A "forward" contract calls for a *future* sale. During the interval between signing the contract and closing the sale, the seller treats the funder's upfront cash like a tax-free deposit.

If a prepaid forward contract meets specified requirements, it has the advantage of providing cash to the seller with no immediate tax, just like a loan. However, getting the right documentation is critical. Whatever structure is used, it is important for lawyers and clients to consider taxes. You do not want to enter into a forward contract, pay a funder a steep return, and find out that you must pay taxes *now*. You also don't want to later learn that you cannot deduct a big payment of proceeds to the funder or somehow offset it against income from the transaction that generated the proceeds.

Economic terms affect tax treatment, too. A prepaid forward contract may involve the sale of stock or other assets. It may involve the assignment of all or a portion of a disputed legal claim (or, more likely, its proceeds) if there is a recovery. Many fact patterns are possible with securities sales or litigation finance, and they raise tax issues.

Defined

A traditional forward contract has been defined as an executory contract under 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.[2] This definition suggests that these are simple arrangements. In practice, however, they may be anything but.

A "prepaid" forward contract requires the buyer to pay the seller the purchase price at the time the parties enter into the contract (as opposed to the delivery date). The tax goal is simple. Taxpayers who enter into forward contracts to sell property in the future are generally not treated as having sold the property, even if they own it at the time of contracting.[3]

A prepaid forward contract remains open, like an option, until it is sold, exchanged, settled, or allowed to lapse.[4] As in a loan, money may change hands, but there should be no immediate taxable event to the forward seller, at least if the future sale involves a *variable* amount of proceeds. Until the transaction closes, it is typically impossible to determine how the advance payments should be reported.

In that case, there is little choice but to hold the transaction open. The advance payment to the seller can then be considered equivalent to a deposit, which does not trigger current tax. This is analogous to the treatment of "put" and "call" options, in which the writer of the option does not have a taxable event unless and until the option expires or is exercised or terminated.[5]

Seminal Ruling

In Rev. Rul. 2003-7, 2003-1 C.B. 363, the IRS approved open transaction treatment for a variable prepaid forward contract involving the sale of stock. In that ruling, the IRS held that no

---

[1] Although many prepaid forward contracts call for the delivery of property (*e.g.*, shares of stock), they generally permit cash settlement. We will focus on prepaid forward contracts settled in cash, which typically represent the proceeds received by the contract seller from disposing of property, settling litigation, etc. Because the buyer is paying cash in exchange for a right to future cash proceeds, it is common to refer to the buyer as the "funder."

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

[3] *See Lucas v. North Texas Lumber Co.*, 281 U.S. 11 (1930).

[4] *See, e.g., Virginia Iron Coal & Coke Co. v. Commissioner*, 37 B.T.A. 195 (1938), *aff'd*, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1938); *see also* JCX-21-08.

[5] Rev. Rul. 58-234, 1958-1 C.B. 279; and Rev. Rul. 78-182, 1978-1 C.B. 265.

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 quantity 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 his obligations under the agreement. Significantly, the IRS also ruled that there was no constructive sale of stock under section 1259. If a shareholder owns appreciated stock, section 1259(c)(1)(C) requires him to recognize gain if he enters into a forward contract to sell those or substantially identical shares.

That would eliminate the tax deferral otherwise available to an open transaction. However, in Rev. Rul. 2003-7, the IRS held that section 1259 does not apply to a shareholder's entry into a prepaid forward contract if it is variable enough. Section 1259(d)(1) defines "forward contract" to mean a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.

The contract in Rev. Rul. 2003-7 provided for a 25 percent swing in the number of shares to be delivered. The IRS concluded, based on this "significant variation," that the arrangement was not a forward contract under the statute. Therefore, it did not trigger an immediate constructive sale of shares under section 1259(c)(1)(C).

Anschutz Tax Cases

In *Anschutz*,[6] the Tax Court and Tenth Circuit reviewed a prepaid forward sale of stock that was coupled with a loan of the pledged shares to the forward purchaser. The courts held that Anschutz was subject to tax immediately on receipt of the upfront cash. The courts concluded that the transaction, taken as a whole, immediately transferred the benefits and burdens of ownership to the forward purchaser, which used the pledged shares to cover its short sales obligations.

The benefits and burdens transferred to the forward purchaser 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, and in time, taxpayers besides Anschutz ended up with less than what they had bargained for.[7]

In Notice 2008-2, 2008-2 IRB 252, the IRS requested comments from the public on the tax treatment of prepaid forwards. The IRS stated that it was considering whether the parties to these transactions should be required to accrue income and expenses during the term of the transaction, even if the transaction was not otherwise classified as indebtedness for federal income tax purposes. Issues on the table included the following:

- The appropriate method for accruing income or expenses if that is deemed appropriate. Examples mentioned in the notice included a mark-to-market method or one resembling the noncontingent bond method set forth in reg. section 1.1275-4. The noncontingent bond method generally involves constructing a projected payment schedule for the debt instrument and applying rules like those used for accruing original issue discount.
- The appropriate character (capital vs. ordinary, and if ordinary, whether interest) of any income accruals required under such an accrual regime, as well as the character of amounts less than or more than these accruals.
- Whether the tax treatment of the transactions should vary depending on the

[6] *Anschutz Co. v. Commissioner*, 135 T.C. 78 (2010), *aff'd*, 664 F.3d 313 (10th Cir. 2011).

[7] *See* Jeremiah Coder, "More Taxpayers Settling Their Variable Prepaid Forward Cases," *Tax Notes*, Jan. 4, 2012, p. 166.

nature of the underlying asset (for example, stocks vs. commodities).

- Whether the tax treatment of the transactions should vary depending on whether the transactions were (1) executed on a futures exchange or (2) memorialized in an instrument that is traded on a securities exchange.
- Whether the transactions should be treated as indebtedness in accordance with 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. Also, an interest charge applies as though the gain had been recognized in prior years.

The IRS also issued Rev. Rul. 2008-1, 2008-2 IRB 248. In that ruling, a foreign-currency-linked transaction that resembled a prepaid forward contract 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 euros, and at maturity three years later, the issuer was required to pay the U.S. dollar equivalent of 75 euros, plus the U.S. dollar value at maturity of a return based on euro interest rates.

The IRS noted that the instrument, in form, resembled a U.S. dollar-denominated derivative contract in which the holder prepays its obligations under the contract and is entitled to receive a return based exclusively on the value of property at maturity. However, IRS officials suggested in later discussions that this ruling had little bearing on prepaid forward contracts that do not involve the specific foreign currency rules of section 988.[8]

No Current Taxation

Despite the unsettling questions raised by Notice 2008-2 and *Anschutz*, the IRS has not withdrawn or modified Rev. Rul. 2003-7. In fact, the 18 intervening years have generally gone pretty well for taxpayers using variable prepaid forward contracts. Even in *Estate of McKelvey*,[9] a case in which the taxpayer came up notably short, neither the parties nor the Second Circuit questioned the basic premise that these transactions can permit the seller to receive upfront cash without a taxable event.

Thus, it seems clear that taxpayers can rely on the favorable principles of Rev. Rul. 2003-7. When the funder tenders the prepaid amount under a contract that tracks Rev. Rul. 2003-7, the seller should be able to pocket the cash without paying any current tax. Tracking the ruling closely is best, of course, and doing so should make the tax opinion writer's job easier. The more the deal varies from the ruling, however, the harder it will be to opine that the upfront payment is not gross income to the seller upon receipt.

The optimal "no income yet" conclusion seems readily attainable in a stock sale with the right documentation. It may also be available in a forward sale of proceeds of a legal claim involving: (1) the receipt of an upfront cash payment; (2) an agreement to deliver proceeds in an amount that varies significantly depending on the amount of the recovery and its timing; (3) a pledge of the claim or its proceeds; (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

Plainly this is tax deferral, not tax avoidance. There will be inevitable 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.[10]

---

[8] *See* comments of Jeffrey Dorfman, chief of Branch 5, IRS Office of Associate Chief Counsel (International), quoted in Crystal Tandon, "IRS Remains Open on Prepaid Forward Contract Treatment" (Feb. 21, 2008).

[9] *Estate of McKelvey v. Commissioner*, 906 F.3d 26 (2d Cir. 2018). The issue in *McKelvey* was not the validity of the shareholder's original prepaid forward contracts, but rather the effect of subsequent agreements in which he paid millions of dollars to postpone their settlement and valuation dates until after his death. *See also* Robert W. Wood and Donald P. Board, "Monster *McKelvey* Estate Tax Case and Litigation Finance," *Tax Notes*, Sept. 4, 2017, p. 1299.

[10] *See* ILM 201025047.

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 — Stock

Seller S enters into a prepaid forward contract for 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.

Buyer B's perspective is the mirror image of the seller's. If the forward is physically settled, B has no realization event. B has simply purchased the stock with its upfront payment, which will become $100 of basis in the shares.

If the forward contract is settled in cash, B is effectively selling his rights under the contract to S for the settlement payment. Because B acquired those rights by paying S the initial $100, B's basis in the forward contract will be $100. Hence, B should recognize gain or loss on settlement based on the difference between S's cash payment and B's $100 basis in the contract.

Example — Litigation Proceeds

Suppose that P, the plaintiff in a lawsuit, enters into a contract to sell F, a litigation funder, a variable amount of any proceeds P recovers in the action. F immediately pays P the purchase price ($100), which P uses to pay his legal expenses. Fifteen months later, P settles his case for $500. P directs the defendant to pay $250 to F, which represents F's share of the case proceeds under the contract.

Because the contract involves litigation proceeds, it is almost inevitably settled in cash. A successful plaintiff generally realizes an economic *loss* on the funding transaction. Here, P received $100 upfront, but he ended up having to deliver $250 to F, saddling P with a $150 loss. By the same reasoning, the transaction generated a $150 profit or gain for F.

Forward Contracts to Issue Stock

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 section 1032. 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.

After all, the corporation has the same economic gain or loss regardless of whether it issues the stock for the payment or enters into a cash settlement in lieu of issuing stock. In a cash settlement, the corporation is treated as issuing its stock at the forward contract price and immediately buying it back from the counterparty for its 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 for that stock.[11]

Opinions

Prepaid forward contracts can be a legitimate means of generating cash in a tax-efficient way. They are popular in both litigation funding and stock-monetization transactions. Transactions that stick closely to the pattern set out in Rev. Rul. 2003-7, and that steer clear of the *Anschutz* fact pattern, should be OK. But it should also be remembered that the IRS does not exactly like open transactions.

It is also worth noting that how much the taxpayer stands to lose may depend in large part on how many years elapse between the receipt of the upfront money and the later closing. If it is one year, the taxes at stake might not be disastrous. However, if it is years — say five years as can happen with litigation funding — the consequences of being wrong (including interest charges) can be devastating. That simple observation should mean that a good tax opinion can be a wise investment.

[11] *Id.*

Plainly, tax opinions must be prepared before the return is filed, not later as defensive documents. Ideally, the tax opinion should be prepared in tandem with planning the transaction. That is the best way to help shape the transaction and the agreements in question.

The conventionally expressed reason for getting an opinion is penalty protection. That is a legitimate rationale. However, no client wants the claimed tax position to fail. If all the opinion accomplishes is saving penalties, hasn't the opinion mostly failed? Clients want their tax position to be upheld, or at the very least, compromised on an acceptable basis. A thorough opinion is the best way to achieve that result.

It is rarely (if ever) appropriate to give the entire opinion to the government, except in shelter cases. That is why keeping the opinion protected by attorney-client privilege is so important. To preserve privilege, one can give the return preparer a brief summary or use a *Kovel* letter. That way, you can keep the opinion as a resource for later on.

Opinions are a *really* helpful resource in controversies. In an audit or controversy, there is rarely enough time to do everything you want to do. It is a luxury to cut and paste passages from a thorough legal opinion with facts and authorities. It can spell the difference between a good and a bad or middling result.[12] It is worth considering a tax opinion in many transactions, including entry into a variable prepaid forward contract. ■

[12] For more opinion tips, see Wood, "Debunking 10 Myths About Tax Opinions," *Tax Notes*, Aug. 17, 2015, p. 789.