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Re: *Timing and Character Rules for Prepaid Forwards and Options*

Lady and Gentlemen:

The enclosed Tax Section Report, No. 990, drafted primarily by

David M. Schizer, co-chair of the Section's Committee on Financial Instruments, discusses possible changes to the timing and character rules for prepaid forwards and options. The Treasury Department has expressed interest in studying these rules. This report addresses only contracts on which the underlying property is a financial instrument or a commodity (including financial-instrument or commodity forwards and options that provide for physical settlement).

Because parties who prepay are rewarded for parting with the use of their money, we recommend imputing interest on (i) prepaid forwards (ii) deep-in-the-money options and (iii) long-dated options. This interest imputation should improve the system's accuracy without imposing undue complexity, although the effect on the system's consistency, and thus on planning opportunities, may be ambiguous. We believe this proposal could be implemented through regulations, although the regulatory authority is not entirely free from doubt, and might be confirmed by legislation.

Whereas the contingent debt regulations of Treas. Reg. § 1.1275-4 also impute interest, we recommend divergence from this regime in two respects. First, additional income or deductions claimed upon realization should be capital, rather than ordinary. This approach is faithful to the general practice of treating risk-based payments as capital and conforms more closely to the treatment of most other investments. Second, physical settlement should not be treated as a realization event for the purchaser. Thus, there would be no inconsistency with the treatment of nonprepaid forwards and options that are not long-term or deep-in-the-money. We further recommend conforming changes be considered for the contingent debt regulations. At a minimum, clearer guidance should distinguish contingent debt from other financial instruments that provide for prepayments.

We also analyze three alternative regimes. Current law is simpler than our proposal but fails to account accurately for the time value associated with prepayments. Extension of the contingent debt regulations would share our proposal's accuracy-related benefits but would lack the other advantages described above. Mark-to-market accounting would be more accurate, but would entail significant valuation issues and could distort behavior when applied narrowly.

If we can be of further assistance in your consideration of any of the issues addressed in the enclosed report, please contact me.

Respectfully submitted,

RAJ:msv
Enclosure

NY2:#4406275

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