Tax Report #954

New York State Bar Association

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NYSBA

June 15, 1999

The Hon. William V. Roth, Jr.
Chairman, Senate Finance Committee
United States Senate
104 Hart Office Building
Washington, D.C. 20510

Dear Senator Roth:

Enclosed is a report of the Tax Section of the New York State Bar Association considering possible statutory changes to the scope of section 1032 of the Internal Revenue Code. The enclosed report recommends that Congress and the Treasury Department reexamine the scope of section 1032, which generally provides for nonrecognition of gain or loss with respect to certain transactions in a corporation's own stock. The Administration's recent proposal to amend section 1032 to tax corporations on a time-value element in forward sales of their own stock should be considered as part of this broader reexamination.

As the enclosed report explains, the scope of current section 1032 is unclear and that, even to the extent it is clear, section 1032 treats economically equivalent transactions inconsistently. We are concerned that increased availability of equity-linked derivatives may enable some corporations to take advantage of this uncertainty and inconsistency to whipsaw the government by claiming nonrecognition treatment for gains while deducting losses from transactions linked to their own stock.

In the enclosed report, we consider three alternative approaches to changing the scope of section 1032 to address uncertainty and whipsaw potential of current law, and we conclude that the best approach is to expand that scope. In addition, we consider alternatives, including the Administration's proposal, for dealing with the time-value element in forward contracts. We believe that section 1032 should be amended to deny nonrecognition treatment to income from certain transactions that are economically equivalent to loans. For the reasons explained in our report, however, we do not support the Administrations' proposal. We propose, instead, enactment of a narrower approach to this problem that would be fully adequate to address the concerns underlying the proposal.

We would be pleased to discuss the enclosed report with you at your convenience.

Very truly yours,

Harold R. Handler
Chair

Enclosure

cc: Mark Prater, Esq.

June 16, 1999

New York State Bar Association
(Tax Section)
Report on Section 1032

I. Introduction.

This report, prepared by an ad hoc committee of the Tax Section of the New York State Bar Association (the "Committee"),[1] considers possible statutory changes to section 1032. The Committee believes that reexamination of the scope of section 1032, which generally provides for nonrecognition of gain or loss realized by a corporation with respect to certain transactions in its own stock or options on its own stock, is necessary in light of recent developments in financial markets. These developments include availability to corporations of new kinds of derivatives and financial instruments linked to their own stock. We believe that the Clinton Administration's proposal to amend section 1032 to tax a corporation on the "time-value element" in a forward sale of its own stock (the "Administration Proposal")[2] deals with only one aspect of this issue and should be considered in the context of this broader reexamination of the scope of section 1032.

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1 The Committee was chaired by David S. Miller, who was the principal drafter of the report, with substantial assistance from Samuel J. Dimon, Harold R. Handler, Robert H. Scarborough, and Michael L. Schler. The Committee also included Jose Berra, Steve Bortnick, Daniel Breen, Thomas Brenner, Robert Jacobs, Oggie Caginalt, Robert Cudd, Jules Goodman, Viva Hammer, Laura Hegedus, Gerald P. Kaufman, Mark H. Leeds, Jeffrey Piemont, Thomas Prevost, Richard Reinhold, Po Y. Sit, Andrew Solomon, Linda Z. Swartz, and Diana Waldman. Helpful comments were received from Peter C. Canellos and Bruce Kayle. The recommendations in this report reflect decisions of the Executive Committee of the Tax Section.

2 Department of the Treasury, General Explanation of the Administration's Revenue Proposals at 106 ("Require Accrual of Time-value Element on Forward Sale of Corporate Stock") (February 1, 1999).

II. Summary of Recommendations.

We are concerned that inconsistent treatment of economically equivalent transactions under current section 1032, and uncertainty as to its scope, may result in whipsaw against the government. Although there are several alternative approaches to addressing this problem, we believe that the best approach is to expand the scope of section 1032 to provide that a corporation does not recognize gain or loss from transactions in its own stock or in related derivatives. Section 1032 would then clearly provide, for example, that a corporation does not recognize gain or loss from an equity swap on its own stock or from cash settlement of forwards or other derivative financial instruments, to the extent attributable to its stock.

We do not support the Administration Proposal as to the time value component in forward contracts on the taxpayer's own stock. We do, however, support a narrower exception from nonrecognition treatment under section 1032 that would require a corporation that retires its stock and substantially contemporaneously enters into a contract to sell its stock forward at a fixed price to recognize as income a time-value element. We believe that this narrower exception would be fully adequate to address the concern that current section 1032 may permit corporations effectively to earn interest income tax-free through "cash-and-carry" transactions on their own stock.

This report includes, in an appendix, proposed statutory language to implement our recommendations, as well as a detailed explanation of this proposed language.

III. Background and Need for Reexamination of Section 1032.

Section 1032 currently is composed of three sentences:

(a) **Nonrecognition of Gain or Loss.** No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).

(b) **Basis.** For basis of property acquired by a corporation in certain exchanges for its stock, see section 362.

Section 1032 serves two different (and at times conflicting) policies. The first policy is proper measurement of income. In a "core" section 1032 transaction, when a corporation issues or purchases its stock at fair market value at the time of issuance or purchase, the corporation has no economic gain or loss; thus, by mandating nonrecognition treatment for these transactions, section 1032 results in proper measurement of a corporation's economic income.[3] Courts have long recognized that, in this situation no gain or loss should be recognized.[4]

In contrast, upon the issuance or repurchase by a corporation of its stock for more or less than the stock's fair market value as of the time of settlement (for example, as a result of the exercise of an option by a holder), or upon the lapse or repurchase of an option that was issued by a corporation with respect to its stock, the corporation arguably realizes economic gain

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3 To illustrate the operation of section 1032 in this situation, assume that a corporation issues two shares of stock for $50 each and buys an asset for $100. The asset appreciates to $200, the corporation sells the asset and uses the proceeds (ignoring corporate tax on gain on the sale) to redeem one share for $100, which it holds as treasury stock. The corporation reinvests its remaining $100 (ignoring tax on gain on the sale) in a new asset, which grows in value to $200. At this point, the corporation's sole shareholder has a 100% interest in the $200 asset. If the corporation resells its treasury share to an unrelated person for $200, the original shareholder has no economic gain because the value of his share has remained static at $200 (50% of $400). Similarly, the corporation has no economic income as a result of the reissuance of the treasury share because the unrecognized gain in its assets also is static at $100. (If the corporation were subject to tax on the $100 difference between the sales price of the treasury share and its purchase price, and on the $100 appreciation in the asset, it would be subject to tax twice. Stated another way, the appreciation in the value of the corporation's stock was entirely attributable to the appreciation in value of its asset.)

4 For example, in Simons & Hammond Manufacturing Co. v. Commissioner, 1 B.T.A. 803 (1925), the taxpayer purchased 94 shares of its stock for about $21,000, held them as treasury shares, and resold them for about $10,000. In denying the taxpayer its claimed loss on the transaction, the court held:

> [I]t was urged upon us that shares of its issued and outstanding stock repurchased by a corporation representing treasury stock, are in as full a sense an asset as would be Liberty bonds or commercial securities. An analysis of this position discloses its fallacy... There may be such a treatment of the transaction by the corporation as to show a bookkeeping loss or gain (as was the case here), but it is not actual and real. For that reason we hold that there was in the instant appeal no actual or realized loss.

1 B.T.A. at 808.

or loss.[5] By providing for nonrecognition in this situation, section 1032 arguably does not further the policy of accurate measurement of the corporation's (or its shareholders') economic gain or loss.[6] Section 1032 does, however, serve a second policy of avoiding uncertainty and anti-government whipsaw in such cases, and this policy has clearly motivated Congress.[7]

We believe that section 1032 as applied to the kinds of transactions originally contemplated by Congress appropriately furthers one, if not both, of the two foregoing policies.

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5 This argument assumes that a corporation's economic income is equal to the change in the value of its assets over the change in the negative value of its liabilities, and that all claims against a corporation, except for those of its shareholders, are treated as liabilities for this purpose. However, as discussed below, legitimate questions may be raised as to these assumptions, including as to the proper measure of a corporation's liabilities for this purpose.

6 This failure is illustrated by a corporation that has received a premium for issuing a warrant that expires unexercised. In this case (and in contrast to the "core" section 1032 situation), the corporation's common shareholders have economic income because the option premium represents an additional asset that is shared among a static number of common shareholders (assuming that the option holder is not viewed as owning the underlying stock). If one views the corporation's economic income as corresponding to that of its common shareholders (i.e., the aggregate increase in the value of their shares), the corporation would also be viewed as having economic income. Moreover, the situation arguably produces a tax arbitrage because the optionholder would be entitled to a capital loss that is not offset by corporate-level taxable income or gain. This capital loss may be offset by capital gain recognized by the common shareholders on disposition of their shares (which theoretically should have increased in value to reflect the forfeited option premium); however, our tax system is generally designed to tax income earned with respect to corporate equity investments twice, and thus, arguably requires recognition of corporate-level gain as well.

7 Whipsaw potential and uncertainties led Congress to introduce section 1032 in 1954 and, in 1984, to add the second sentence of section 1032(a). See H.R. Rep. No. 83-1337, 268 (1954) (introduction of section 1032), reprinted in 1954 U.S.C.C.A.N. 4025, 4410; S. Rep. No. 83-1622, 426 (1954) (same); H.R. Conf. Rep. No. 98-861, 827-28 (1984) (second sentence of section 1032(a)); H.R. Rep. No. 98-432, 1196-97 (1984) (same). Prevention of whipsaw, and the consistent treatment of the repurchase of a warrant by an issuing corporation and the exercise of a warrant followed by a repurchase of the newly-issued stock) were the only explanations advanced for the expansion in 1984 of section 1032 nonrecognition treatment to the acquisition or lapse of an option on a corporate taxpayer's own stock. See H.R. Cong. Rep. No. 861, 98th Cong., 2d Sess. 827-28 (1984); H.R. Rep. No. 432, 98th Cong., 2d Sess. pt. 2 at 1196, 1197 (1984); S. Prt. No. 169, 98th Cong., 2d Sess. 183, 184 (1984); Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 160-61.

We are concerned, however, that taxpayers engaging in transactions that were not contemplated by Congress may be able to take advantage of the scope of current section 1032 to achieve results that are not consistent with either of these policies. In particular, we are concerned that current section 1032 may result in the unintended inconsistent treatment of economically equivalent transactions and may facilitate tax-motivated arrangements by corporations designed to result in understatement of their economic income.

Section 1032 may result in inconsistent treatment of economically equivalent contracts because it only applies—or at least only clearly applies—to the transactions specifically described in the statute. Thus, for example, section 1032 does not address the treatment of a corporation that enters into an equity swap (or is a party to other financial instruments) with respect to its own stock.[8] Accordingly, corporations that realize losses under such notional principal contracts may take the position that section 1032 does not deny recognition of those losses, even though section 1032 would apply to combinations of forwards and/or options that are economically equivalent to those contracts. Other corporations that realize gains under such notional principal contracts, however, may take the position that section 1032 does apply to those contracts.[9]

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8 For example, assume that a publicly-traded corporate taxpayer enters into a contract, documented on an ISDA master agreement, that provides for a notional amount equal to the initial dollar value of a fixed number of shares of the taxpayer's common stock. The contract requires the taxpayer to make periodic payments equal to the notional amount times LIBOR and, at maturity, to pay a cash amount equal to the decrease in value (if any) of the fixed number of shares. The contract also provides for the taxpayer to receive periodic amounts equal to any dividends paid on the fixed number of shares of the taxpayer's stock and, at maturity, to receive the increase in value (if any) of the fixed number of shares. Section 1032 does not address the federal income tax treatment of the taxpayer that enters into this contract.

As another example, section 1032 does not squarely address the treatment of a corporation that buys an option on its own stock and then sells that option at a gain or loss.

9 Other uncertainties and issues exist with respect to section 1032, which are not discussed in this report. For example, this report does not discuss the treatment of a subsidiary that deals in stock of its parent. These and other issues, and the history of section 1032, are discussed comprehensively in Michael L. Schler, "Exploring the Boundaries of Section 1032," 49 Tax Lawyer 543 (1996), and Harold R. Handler "Will the Bull Market of the 1980s Lead to Answers for Warrants?" 37 Tax Lawyer 245 (1984).

Thus, section 1032's failure to address the treatment of a corporation that enters into certain contracts linked to its own stock may result in two different kinds of inconsistency. First, corporations entering into a particular kind of contract not clearly addressed by section 1032 may take different positions as to whether section 1032 applies, depending on whether they realize a gain or loss. When the law is not clear, taxpayers generally will select the most favorable interpretation, and thus the government faces the risk of whipsaw. Second, a corporation entering into contracts that are subject to section 1032 (such as a series of options) will be taxed differently from a corporation entering into economically equivalent contracts not subject to section 1032, even though the two corporations realize the same economic gain or loss. Since taxpayers choose the form of their transactions, they may be able to structure a transaction to be within or outside section 1032 without changing its substance.

The potential for inconsistent treatment of similar transactions has been increasing as a result of the development of new types of financial instruments over the last 15 years, including, for example, equity swaps and other notional principal contracts linked to a corporation's own stock, and equity-linked contingent debt.

In addition to these opportunities, section 1032 nonrecognition treatment may permit a corporation effectively to avoid tax on economic income that is equivalent to interest. A corporation whose shares are publicly traded can use cash it otherwise would have invested to purchase its own shares in the market and simultaneously enter into a forward contract to sell the same number of shares at a fixed price. The forward price will equal the market price of the shares when the contract is entered into, increased by interest on that price and reduced by expected dividends.[10] Thus, the corporation is assured of receiving upon settlement of the forward contract an amount of money equal to the money paid to purchase its shares, plus an additional amount equivalent to interest.[11] The corporation has entered into a transaction that

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[10] See Richard A. Brealey and Stewart C. Myers, Principles of Corporate Finance 637-38 (4th ed. 1991).

[11] Although the forward price received by the corporation reflects reduction for expected dividends, this reduction is offset by the savings to the corporation of not paying dividends on the shares it has purchased. To the extent that actual dividends differ from the expected dividends used to determine the fixed forward price, the corporation that retires its stock and sells it forward is in a different position from that of a corporation that leaves its stock outstanding and buys a debt instrument.

provides a fixed time-value return on its initial investment, and thus the transaction is economically quite similar to the purchase of a debt instrument. Under section 1032, however, this return is tax-free.

We are concerned that all the inconsistencies described above (both in the general scope of section 1032 and in its treatment of retirements combined with forward sales) present whipsaw and abuse potential; the government faces the risk that income from some transactions will not be recognized even though those transactions are economically equivalent to taxable transactions. In addition, the government faces the risk that deductions are allowed for losses from transactions that are equivalent in substance to transactions that would produce nontaxable income, or—because taxpayers may take different positions under current law—even in the same form as such transactions. To avoid these inconsistencies, we believe it is necessary to amend section 1032 either to provide clearly for nonrecognition treatment in all transactions that involve the issuer's stock or, alternatively, to limit nonrecognition of gain to a clearly-defined narrow set of cases and disallow losses in those cases as well. We believe, however, that a different approach should be adopted for dealing with corporations that retire and simultaneously sell forward their own stock.

IV. Alternative Approaches to Reforming Section 1032.

A. Issues To Be Addressed.

In considering alternative ways to address the inconsistencies resulting from section 1032, two conceptually distinct issues must be addressed.

The first issue is the extent to which a corporation that enters into contracts linked to its own stock should recognize gain or loss attributable to fluctuations in the value of that stock. Stated differently, how far, if at all, should section 1032 nonrecognition treatment extend beyond "core" cases of purchase and issuance of stock at fair market value?

The second issue—addressed by the Administration Proposal—is whether to identify and treat separately the time value of money element in a contract linked to the taxpayer's stock, under circumstances in which the tax law would not do so if the same contract were linked to other property. Certain financial instruments, including options and forward contracts, contain a time value component that, from a policy standpoint, arguably should be broken out and taxed under rules applicable to interest. Because this is true regardless whether the instrument is linked to the taxpayer's own stock or to other property, one might argue that the tax law should break out a time value component from options and certain forwards on the taxpayer's stock only if the law also does so for all such options and forwards. The issue of how to treat the time value component in derivatives is presented not only for transactions described in section 1032 but for all derivatives that contain such a component. Thus, the question of how to treat equity derivatives entered into by corporations is part of the broader question of the proper treatment of the time-value component in all kinds of derivatives for all taxpayers.

In response, it might be argued that proper treatment of the time-value element is more important if section 1032 is potentially applicable. In other cases, generally only the timing and character of income and expense (and not the absolute amount of the income and expense) depend on whether an interest element is carved out. When, however, the financial instrument is subject to section 1032, the stakes are arguably higher. Failure to treat separately the interest element in an option or forward subject to section 1032 will result in permanent elimination of gain or loss that may be equivalent economically to interest income or expense. Accordingly, the tax system's interest in identifying and properly taxing the time-value element in a derivative is potentially greater where section 1032 applies than where it does not.

Obviously, these two issues are related. The broader the scope of nonrecognition treatment under section 1032, the more important it becomes to consider carve outs from nonrecognition treatment for the time-value component of derivatives linked to the taxpayer's stock.

In the remainder of this report, several alternative approaches to resolving each of these two issues—including the Administration Proposal—are considered. Before considering specific alternatives, it is important to note that there are a number of potentially conflicting tax policies that must be balanced. Because these different policies may conflict, there are no simple or clear answers to the issues that reform of section 1032 presents. The policies that must be balanced include the following seven: (i) economic taxation of income, (ii) certainty of result, (iii) prevention of anti-government whipsaw and abuse, (iv) consistent tax treatment of economically similar transactions, (v) administrability, (vi) stability of the tax laws, and (vii) public perception. In this report, we evaluate each of the alternatives that we consider in light of the policies they would advance or impede.

B. Alternative Approaches to Scope of Section 1032.

In considering possible changes to the scope of section 1032, the Committee considered three alternative ways of addressing current law inconsistencies. None of these three alternatives deals specifically with the taxation of the time-value element in certain equity-linked derivatives and forwards. After discussion of the three alternative approaches to changing the scope of section 1032, we consider alternative approaches for dealing with that question.

1. **Limitation of Section 1032 to "Core" Cases.** Section 1032 nonrecognition treatment could be significantly restricted by limiting it to those "core" section 1032 transactions in which a corporation actually issues or purchases its own stock for the stock's fair market value at the time of settlement. Under this approach, corporations would recognize taxable gain or loss (under generally applicable principles) on all cash-settled financial instruments that reference the taxpayer's stock. In addition—in a departure from tax rules that generally apply to physically settled options and forwards—corporations would recognize taxable gain or loss on all financial instruments physically settled with the taxpayer's stock to the extent the amount received in respect of the financial instrument differs from the fair market value on the settlement date of the stock used to settle the financial instrument.[12] This approach would, among other things, effectively repeal the 1984 amendment to section 1032, and provide nonrecognition treatment to a corporation only with respect to the actual issuance or purchase of its own shares.

This approach can be viewed as properly measuring economic income, but only if one accepts both of the following premises: (i) a corporation's economic income is equal to the change in the value of its assets over its liabilities,[13] and (ii) the liabilities of a corporation should

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[12] To illustrate how this approach might work, consider a corporation that issues two shares of common stock for $50 each, and issues a warrant for $10 that permits its holder to buy for $50 a newly issued share of stock. Assume that the corporation invests its $110 proceeds in an asset. If the value of the asset does not change by the exercise date of the warrant and the warrantholder does not exercise the warrant, the corporation would be subject to tax at such time on $10. If, on the other hand, the asset appreciates to $160 and the warrantholder exercises the warrant and pays $50 for a share worth $70 (1/3 x [$160 + $50]), the corporation would have a loss of <$10> ($60 received [including $10 of premium] less $70 fair market value of stock on the issue date).

[13] The Haig-Simons definition of income is consumption plus change in net worth. Since a corporation does not "consume" in the Haig-Simons sense, the definition in text appears (continued...)

include for this purpose all claims against a corporation except those that are treated as equity for tax purposes.[14] If one accepts these premises (and this approach is applied to a corporation with a relatively simple capital structure), this approach would require corporations to take into account gain or loss from transactions linked to their own stock, but only if it corresponds to gain or loss to shareholders. In addition, it would provide certainty of result. Furthermore, it would ensure consistent tax treatment of corporate taxpayers that enter into economically similar contracts or positions--so long as they are not classified as stock for tax purposes--regardless of whether they are in the form of options, forwards or notional principal contracts, and regardless of whether they are cash-settled or physically-settled.

The second of the two premises underlying this approach is open to serious question because it assumes a distinction between financial instruments that are treated as stock and those that are not; this distinction may not, however, be tenable from a policy standpoint. An equity-linked derivative may be very similar economically to a class of stock. For example, under this approach, repurchase of common stock at its fair market value would not give rise to gain or loss to the corporation, but cash-settlement of an economically similar equity-linked derivative at its fair market value would give rise to gain or loss.[15]

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to be a reasonable application of the Haig-Simons definition of income to a corporate taxpayer.

14 This approach would rely on the line drawn under current law between interests representing equity in a corporation (nonliability) and nonequity derivative interests (liability). We note that, in drawing this line, current law may look not only at the form of an interest, but also its substance. See, e.g., Revenue Ruling 82-150, 1982-2 C.B. 110, 110 (deep-in-the-money option treated as equity interest).

15 One way to deal with this objection would be limit section 1032 treatment to issuances and retirements of common stock at fair value. Under such a variation on the first approach, a corporation could recognize gain or loss on issuances and retirements of other equity interests, including preferred stock. Under this variation, treatment of derivatives and economically equivalent classes of stock would be treated consistently (i.e., both would be outside the scope of section 1032); classes of stock other than common stock would be treated in the same manner as liabilities for purposes of section 1032. This variation, it might be argued, better measures the economic income of the corporation (if that is viewed as equivalent to the economic income of its common stockholders). Arguably preferred stock bearing an interest-like return and which does not share in the residual assets or income of a corporation (or even all noncommon equity interests) should be treated as liabilities for section 1032 purposes rather than as equity. In particular, the ability of a corporation to redeem preferred stock at a discount to its (continued...)

In addition to resting on a questionable distinction between stock and economically similar financial instruments, this approach has a number of disadvantages. First, it would be at variance with long-settled tax treatment of transactions by a corporation with respect to its own stock, and therefore would tend to destabilize the tax system. For example, absent a special exception, it could result in recognition of gain or loss on settlement of a stock subscription agreement, which has not been the case since the earliest days of the income tax.[16] The law has long treated transactions that relate to a corporation's capital structure as not giving rise to income or deductible loss. Second, it would present serious valuation issues whenever a corporation settles a warrant or other derivative with or for nontraded stock (or even a large block of publicly-traded stock that potentially reflects a premium). Third, it would permit issuers to generate deductions in a rising market for their shares if the value of shares delivered upon exercise of an option exceeds the amount realized by the corporation, or if the corporation buys in warrants and options prior to exercise for an amount in excess of the premium received. Allowance of such deductions could present serious problems of public perception. Fourth, this approach would increase the importance of the distinction between common stock and derivatives linked to a corporation's common stock. A corporation that issues or purchases a security that is considered to be equity in a corporation would be subject to section 1032 on settlement, but a corporation that issues or purchases an economically similar security that is

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issue price, thereby generating a loss for the preferred shareholder but increasing the assets available for distribution to common shareholders, suggests that the claims of "plain vanilla preferred" shareholders should be regarded as liabilities for section 1032 purposes.

If the variation described above (limiting section 1032 treatment to common stock) were considered, difficult issues would be presented by corporations issuing classes of common stock that are not equally entitled to a pro rata share of the corporation's residual net assets and income (such as tracking stock).

The proper treatment of preferred stock, and the proper treatment of tracking stock, are both beyond the scope of this report. We raise these issues only to show that first approach to section 1032 reform considered in this report (at least without the variation described above) would necessarily rely on a questionable current law distinction between equity and non-equity interests in a corporation. Because of the disparate treatment under current law of economically similar interests in a corporation, it is not at all clear that the first approach really most accurately measures income.

16 See, e.g., Illinois Rural Credit v. Commissioner, 3 B.T.A. 1178 (1926) (deposit pursuant to stock subscription agreement does not give rise to corporate taxable income).

treated as an option or forward contract on its equity would be treated differently. For all the foregoing reasons, the Committee does not recommend this approach.

2. Restriction of Nonrecognition Treatment To Contracts That Must Be Physically-Settled. Second, section 1032 nonrecognition treatment could be restricted to transactions under which a corporation is required physically to issue or purchase its own stock, regardless of whether the stock is issued or purchased at its fair market value at the time of settlement. In effect, this would adopt the current section 1032 approach for any transaction involving the issuance or retirement of a corporation's stock. Under this approach, corporate taxpayers would not recognize gain or loss with respect to warrants on their stock so long as the corporation did not have the ability pursuant to the terms of the warrants to settle them in cash. Likewise, a corporation would not recognize gain or loss when it buys or sells options or forward contracts on its own stock that, by their terms, could be settled only by physical delivery of shares. Corporations would, however, recognize taxable gain or loss with respect to any derivative whose terms expressly permit the corporation to settle it in cash. If a contract does not by its terms permit cash settlement, but the parties subsequently agree to cash settlement (e.g., the issuer purchases for cash a warrant that by its terms can only be physically settled), section 1032 would apply. By the same token, if a derivative (such as an equity swap) with respect to the corporation's stock permits or requires cash settlement, the corporation would recognize taxable gain or loss even if the corporation's stock is used as the currency to settle the derivative.

This approach would tax corporations issuing cash-settleable derivatives on what is arguably[17] an economic basis, would not change the current tax treatment for most common capital market transactions (such as the issuance by corporations of traditional warrants), and thereby would avoid difficult valuation issues for these solely physically-settleable transactions. It would also reduce opportunities for abuse and whipsaw against the government, which is one of our principal objectives. In addition, this approach would tax financial transactions that permit cash settlement of such a warrant or option in a manner similar to that in which it would tax equivalent transactions in securities other than the issuer's stock. However, this approach would not tax economically similar transactions the same: a corporation issuing a solely

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[17] For reasons discussed above, this argument may not be persuasive, because it relies on a distinction between interests in a corporation classified as stock and economically similar interests that are not classified as stock.

physically-settleable warrant would not recognize gain or loss on its exercise or lapse; however, a corporation issuing a warrant that may be settled by the issuer in cash would recognize gain or loss upon its exercise or lapse.[18] We are particularly concerned about taxpayers' ability to take advantage of these inconsistencies, especially in transactions involving stock of closely held corporations. For this reason, we do not recommend this approach, although a minority of the Committee endorse it.

3. Extension of Nonrecognition Treatment to Gain or Loss from any Derivative to the Extent It References Changes in the Value of, or Distributions on, a Corporation's Stock. Third, section 1032 nonrecognition treatment could be expanded beyond current law to include gain or loss on any derivative issued or purchased by a corporation to the extent it references changes in the value of the corporation's stock or distributions on the corporation's stock. This approach would prevent anti-government whipsaw and abuse by (and provide for consistent tax treatment of) corporations that enter into equity swaps on their own stock; as previously mentioned, some taxpayers may take the position currently that gain transactions are subject to section 1032 non-recognition treatment while other taxpayers may take the position that loss transactions provide a deduction. This approach would eliminate the uncertainty under current law with respect to the tax treatment of a corporate taxpayer that sells an option (written by a third party) on its own stock or enters into certain derivatives linked to its own stock, and would not present the valuation issues of the first and second approaches described above. Finally, this approach would be consistent with the tax law's historic broad nonrecognition treatment for corporations that deal in their own stock, and therefore would maintain legal stability.

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18 Thus, the corporation could effectively elect recognition or nonrecognition treatment at the inception of the transaction. Despite the different treatment of the two economically equivalent transactions described in text, this approach would not allow whipsaw because the corporation would have to decide when a transaction is entered into (i.e., when it chooses whether a contract will be settleable in cash) whether gain or loss will be recognized.

On the other hand, this approach arguably[19] would not tax corporations on their economic gain; corporations that "win" derivative bets on their own stock would not be taxed, and corporations that "lose" derivative bets on their own stock would not be allowed to take those losses into account. Failure to recognize gain and loss may seem particularly inappropriate where it results from contracts that could never result in issuance or purchase of stock. In opposition to this approach it might be argued that a corporation that bets on its own stock with cash-settled derivatives should be treated in the same way for tax purposes as a corporation that bets on the stock of another corporation or the value of any other property. Finally, this approach introduces the complexity of requiring bifurcation of derivatives that provide for payments determined in part by a corporation's own stock (subject to section 1032) and in part by other factors (not subject to section 1032).

We believe that the three approaches described above reflect the full range of alternatives for avoiding the uncertainty and whipsaw potential of current law. After weighing the advantages and disadvantages of each approach against those of the others, a majority of the Committee recommends adoption of the third approach.

C. Approaches to Taxation of the "Time-Value Element".

After resolving the question of the general scope of section 1032, one may also consider whether and to what extent a carve out from nonrecognition treatment should exist for the time-value element in derivatives that reference the taxpayer's stock. As described above, nonrecognition treatment for these transactions permits a corporation to repurchase its stock and simultaneously to enter into a forward contract to sell the stock in the future at a fixed price, effectively providing the corporation with income that is economically similar to interest income but is tax-free.

A variety of approaches to this issue are possible. At one extreme, one might attempt to identify a time value component in all derivatives linked to a corporation's own stock, including options and equity-linked notional principal contracts, and exclude that time-value element from section 1032 nonrecognition treatment. Under such an approach a corporation

19 This argument (as discussed above) may not be persuasive, because it assumes a distinction between equity and economically similar interests in a corporation that are not classified as equity.

would be taxed on (or would be allowed to deduct) any time value component in any derivative on its own stock. Such an approach would go much farther than the Administration Proposal, and we have not considered it. At the other extreme, one might disregard this time-value element, and thereby continue to permit the kind of transaction just described. Between these two extremes are the Administration Proposal, and a narrower alternative approach, which we recommend. Each of these two alternatives is discussed below.

1. **Administration Proposal.** Under the approach of the Administration Proposal, a corporation that agrees to deliver in the future a substantially fixed amount of its stock (including the cash value) for a substantially fixed price would be treated as if it had issued currently the stock to be delivered in the future for a "constructive note", issued with original issue discount, and providing for a single payment on the delivery date.[20] Although the Administration Proposal is unclear, the issue price of the "constructive note" could be determined under section 1273(b) or section 1274(a) and, in this case, the corporation would recognize original issue discount under a constant yield method over the term of the forward sales contract, equal to the difference between the settlement price and the constructive note's deemed issue price.[21]

This approach would provide for certainty of result, would prevent whipsaw and abuse, and would be administrable. In particular, this approach would prevent the kind of transaction described above. It is more questionable, however, whether the transactions that it would treat in the same way really are equivalent in substance. If one assumes that the stock subject to the forward sale does not provide its holder with any substantial economic or legal rights (e.g., the stock does not pay dividends and does not provide for meaningful voting rights), so that the economic consequences to the corporation's counterparty are identical to the

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20 We presume (although the Administration Proposal is silent on the issue) that the sale of a call and the purchase of a put with respect to a substantially fixed number of the corporation's shares with each option exercisable substantially contemporaneously at substantially fixed strike prices, and a notional principal contract that provides the corporation's counterparty with substantially all of the investment yield (including appreciation) subject to substantially all of the risk of depreciation with respect to the corporation's stock, would also be subject to this treatment.

21 Presumably, in the case of a put and call, the "settlement price" would generally be the strike price of the corporation's call option. In the case of a notional principal contract, the settlement price would be the gross amount of the corporation's payment at maturity.

consequences to a shareholder that purchases stock for a note, this approach would tax the two similar transactions in the same way. As discussed below, however, these assumptions may not generally hold true for transactions that would be subject to the Administration Proposal.

It is also questionable whether this approach would tax a corporation on its economic income. Only if one assumes that the forward price that the corporation is to receive on settlement should be treated as an asset of the corporation before settlement, so that the return on that asset should be taxable to the corporation, would one conclude that this approach taxes a corporation on its economic income.

The description that accompanied the proposal indicates that it was motivated by the economic similarity between a corporation that issues its stock for a note that does not pay interest prior to maturity and a corporation agreeing to issue an equal number of shares of its stock for an amount, equal to the redemption price of the note, payable upon delivery.[22] In the first case, the corporation would generally accrue original issue discount ("OID") in respect of its note but in the second case, no OID would accrue on the forward contract. The Administration Proposal is intended to conform the treatment of the second corporation to the first and require the second corporation to pay tax on some time value of money element in respect of its forward contract.

We are sympathetic to the Administration's frustration with a federal income tax system that at times treats economically similar financial transactions differently. Nevertheless, we believe that the two situations described in the Administration Proposal are generally economically dissimilar, and that it would be particularly inappropriate to tax a corporation as the Administration has proposed. The proposal also raises a number of unresolved issues. Accordingly, for these reasons (discussed more fully below), we oppose the approach of the Administration Proposal to the time value issue.

First, while we agree that the two transactions described above are facially similar in that the cash flows at inception and at maturity of each are identical, and in each case at maturity the investor will hold shares of the issuer's stock, the two transactions are quite different in many respects. The purchaser of stock for a note would be entitled to dividends on

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22 To illustrate, assume that one corporation issues 100 shares of its stock for a zero coupon note providing for a $100 payment in five years and a second corporation agrees to issue 100 shares of stock in five years for a payment of $100 at that time.

the stock, to voting and other shareholders' rights against the issuer, and to transfer the stock free of its obligations under the note. In contrast, the purchaser under a forward contract would not have any right to dividends; although it would be obligated to pay a forward price reflecting expected dividends, its position differs economically from that of a shareholder because actual dividends may differ from expected dividends. In addition, a party to a forward contract does not have voting or other legal rights or the right to transfer its right to receive stock free of its obligation to make payment under the forward contract. Moreover, under current law, the treatment of the purchaser and the issuer are symmetrical: either the issuer includes and the purchaser deducts OID on the note during its term, or neither party accrues or deducts any amounts in respect of the forward contract.

It may be possible to construct a financial instrument that is denominated as a forward contract but is economically identical to a current sale of stock for a note and with respect to which the investor is indifferent as to the absence of interest deductions on the forward contract. However, we believe serious questions would be raised under current law as to the ownership of the stock and thus of characterization of the purchaser's financial instrument as a forward contract—and not indebtedness—for federal income tax purposes. In any event, we do not believe that these transactions are a significant source of abuse.

Second, this approach would create an unfair and noneconomic asymmetry in that it would require inclusion of income by corporations, but would not allow a corresponding deduction to their counterparties.

Third, this approach would not necessarily correctly measure economic income. For example, a corporation would be taxable even in situations where arguably it suffers an economic loss (because, for example, the value of the stock it delivers has a value that is greater than the settlement price).[23]

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23 If the value of the stock delivered at maturity of the forward contract is greater than the settlement price, the corporation arguably has suffered an economic loss on the transaction. Section 1032 prohibits recognition of that loss. Nevertheless the proposal apparently would tax the corporation on a time value component. As drafted, "[t]he proposal would require a corporation. . . to treat a portion of the payment [not of the corporation's realized gain on the forward contract] as a payment of interest" (emphasis added).

Fourth, this approach would create a most peculiar anomaly: corporations, which do not generally recognize income or gain on sales of their stock, alone would be subject to interest accruals of a time value component of a postpaid forward contract (i.e., one in which the forward price is paid on settlement rather than prepaid when the contract is entered into).

As a more general matter, it is not at all clear that interest should be imputed on postpaid forward contracts, and we are particularly concerned about the implications of this approach for the taxation of forward contracts in general. Implicit in this approach is the belief that there is an interest element in every traditional postpaid forward contract; this approach seems to assume that the theoretically correct approach to taxation of a postpaid forward is to impute interest income to the "short" side and interest expense to the "long" side. It follows from this view that—even as a policy matter—no interest income should be imputed to a taxpayer that prepays the forward price. However, prepaid forwards seem to provide a more compelling case for imputation of interest; prepaid forwards and deep-in-the-money options, which provide for significant upfront payments, appear more economically similar to debt instruments than do postpaid forwards.

We recognize that if one were to conclude that interest should, as a policy matter, be imputed on a postpaid forward, one might then conclude that the law should do so only for forwards subject to section 1032; in other cases, the stakes arguably are lower because timing and character, but not permanent elimination, of gain or loss are at issue. The Administration Proposal, however, does not seem to reflect the consideration of the proper taxation of forwards that is necessary before concluding that interest should be imputed on postpaid rather than prepaid forwards.

Congress has already considered the character of time-value components in forward contracts where such contracts are used as part of conversion transactions described in section 1258. In certain cases in which a taxpayer purchases property and enters into a forward contract to sell the property at a fixed price in the future, the character (but not the timing) of a portion of the taxpayer's gain is effectively treated as interest income rather than capital gain.[24] In this situation, in which a short forward contract is combined with a purchase of property in a

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24 See section 1258(c)(1)(2)(A) (limited to situations in which property was acquired and short forward contract entered into "on a substantially contemporaneous basis"). Section 1258 also applies to straddle transactions.

transaction that, taken as a whole, can be viewed as equivalent to a lending transaction, Congress has, solely for character purposes, effectively carved out a time-value element. (As described in more detail below, we would support a similar narrowly focused approach to the time value component of a corporation's short forward contract on its stock combined with purchases of that stock, and we would expand it to apply to the timing of the corporation's income.) However, Congress did not in section 1258 impute interest income in the case of all forward contracts; section 1258 is limited to forward contracts that are part of conversion transactions. Thus, the Administration Proposal is much broader than the approach to forwards taken by section 1258.

Finally, in addition to opposing the Administration Proposal for the foregoing reasons, we believe that it raises a number of collateral issues that have not been addressed. First, it is unclear whether a corporation issuing a forward contract on its own stock would be subject to current interest inclusions based on the discounted future payment (as we have assumed), or would be taxable only upon receipt of payment at the maturity of the forward contract.[25] Second, the rate at which the corporation would accrue interest is unclear. Conceivably, the corporation could accrue interest at the AFR or at its counterparty's "comparable yield." Finally, the proposal is silent on the treatment of transactions that are economically similar to a forward contract (i.e., writing a call option and purchasing a put option).[26]

Thus, while we encourage the Treasury and the Internal Revenue Service to consider the appropriate tax treatment of issuers and holders of various financial instruments—including prepaid and postpaid forwards—and while we share the government's concern with abusive transactions, we believe that the approach of imputing interest income to all corporations that sell forward their own stock would be particularly inappropriate.

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25 The proposal provides that it would require the corporation "to treat a portion of the payment as a payment of interest," but compares the forward contract to a note, which would require current accruals.[25] In addition, what would the treatment be if the put and call provide for net premium to be paid or received, or if the put and call have different strike prices? How would equity swaps be treated?

26 In addition, what would the treatment be if the put and call provide for net premium to be paid or received, or if the put and call have different strike prices? How would equity swaps be treated?

2. Taxation of the Time-Value Element of a "Cash-and-Carry Transaction" By a Corporation With Respect to Its Own Stock. We recommend, instead, a narrower carve out from section 1032 that adequately addresses concerns about abusive transactions, without the disadvantages of the approach of the Administration Proposal. Under the alternative approach to the time value issue we recommend, a corporation would recognize taxable gain with respect to any transaction in which (i) a corporation acquires its own stock, (ii) on a substantially contemporaneous basis the corporation enters into a contract to sell its own stock (whether physically or cash-settled), and (iii) substantially all the corporation's expected return in respect of the transaction is attributable to the time value of its net investment (a "cash-and-carry transaction").[27] In this case, the aggregate amount of the corporation's taxable gain would be equal to the difference between the forward sales price of the stock and the price of the stock purchased, and could be recognized at the maturity of the forward contract or on a constant yield basis over the term of the transaction.[28]

This approach would prevent abuse, and would provide for consistent treatment of lending transactions and economically equivalent cash-and-carry transactions. However, this approach would change current law, and could adversely affect corporations that sell their stock forward contemporaneously with a stock buyback program but without any intent to achieve a tax-free interest-equivalent return. Finally, this approach would introduce some uncertainty for corporations forced to consider the scope of the new rule (e.g., the meaning of the phrases, "on a substantially contemporaneous basis" and "substantially all"). Nevertheless, on balance, we believe that the disadvantages of this approach are outweighed by the need to prevent abuse and to provide consistent treatment of cash-and-carry transactions and economically similar lending transactions.

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27 Cf. section 1258.

28 Alternatively, the corporation's taxable income could be equal to the difference between the forward sale price of the stock and its present value as of the date the contract is entered into, discounted at 120% of the applicable federal rate. Cf. section 1258.

APPENDIX

Recommended Statutory Language and Explanation

I. Statutory Language.

In order to implement our recommendations, section 1032 should be amended as follows:

First, the second sentence of section 1032(a) should be amended to provide:

> No income, gain, loss, or deduction shall be recognized by a corporation with respect to any option or forward or futures contract to the extent it relates (by more than a de minimis amount) to such corporation's stock (including treasury stock), or any other contract or position to the extent it provides for payments calculated (by more than a de minimis amount) by reference to the value of such corporation's stock (including treasury stock), including distributions on such stock.

Second, section 1032(b) should be redesignated as section 1032(d) and new sections 1032(b) and (c) should be added to provide:

> **(b) Exception for Cash and Carry Transactions.** Notwithstanding subsection (a), if (i) a corporation acquires its stock, (ii) within the 60-day period ending 30 days after such acquisition enters into a contract to sell its stock, and (iii) substantially all of the corporation's expected return in respect of such acquisition and contract taken together is attributable to the time value of the corporation's net investment in such transaction, then, unless the corporation demonstrates that such acquisition and such contract to sell did not have a principal purpose of achieving a tax-free return, the corporation shall recognize original issue discount over the term of the sales contract as if it had issued a debt instrument with an issue price equal to the purchase price of the stock acquired and a stated redemption price at maturity equal to the sales price of its stock pursuant to the contract.
>
> **(c) Regulatory Authority.** The Secretary shall prescribe regulations that, for purposes of this section, (1) treat a financial instrument that is not

described in subsection (a) as two or more financial instruments one or more of which are described in subsection (a), (2) treat two or more financial instruments that are described in subsection (a) as a single financial instrument that is not described in subsection (a), (3) treat all or a portion of any interest income or expense on a debt instrument that provides for one or more payments calculated by reference to the value of the taxpayer's stock as subject to nonrecognition under subsection (a), (4) apply subsection (a) to interests in partnerships and trusts that hold financial instruments described in subsection (a), and to financial instruments not described in subsection (a), and (5) determine the issue price and stated redemption price at maturity for purposes of subsection (b) in cases where the stock acquired (or the stock to be sold) are settled in different blocks for various prices or at different times, or the amount acquired is different than the amount subject to the sales contract, or the sales price under the contract is variable.

Finally, the first sentence of section 1032(a) should be amended to include the word ", services" after the word "money".

II. General Purposes of Proposed Changes.

The amendments we propose to section 1032 are designed to have three primary purposes. First, these changes would provide or clarify that nonrecognition under section 1032 applies to a corporation with respect to an option or forward or futures contract on its own stock regardless of whether the financial instrument is issued, purchased, sold, exchanged, settled, terminated, or lapses, and regardless of the medium in which it is settled.[29] Second, these changes would treat any income, gain, loss, or deduction with respect to a conventional equity swap referencing the taxpayer's stock (including dividends paid thereon) as subject to section

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29 We recognize that the transfer by a shareholder of stock to the issuing corporation for cash or property in settlement of a put option held by the corporation's shareholder is technically described in section 311 rather than section 1032. We propose that the legislative history to revised section 1032 indicate Congressional intent for consistent scope and interpretation as between section 1032 and section 311.

1032 nonrecognition treatment.[30] Third, the amendments would tax a corporation that enters into a cash-and-carry transaction with respect to its own stock as if it had issued a debt instrument with original issue discount. Finally, these changes would provide the Treasury with regulatory authority to appropriately interpret the application of amended section 1032(a) to complex financial instruments, integrated positions, debt instruments, interests in partnerships or trusts holding positions in the taxpayer's stock, and new financial products, without further Congressional action.

III. Explanation of Specific Statutory Changes Recommended.

A. Revised Section 1032(a).

We have proposed expanding nonrecognition treatment under the second sentence of section 1032(a) from "gain or loss" to "income, gain, loss, or deduction" because we believe that nonrecognition should apply regardless of the nature of the payment. For example, a corporation should not include or deduct payments on an equity swap with respect to its stock, regardless of whether those payments technically give rise to "income and deductions" or "gain and loss."[31] It is intended (and the legislative history should provide) that section 1032 would apply only to income or deductions for payments required to be made under the terms of a financial instrument, and not for interest (or other) expense in respect of a borrowing to purchase a financial instrument.

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30 Thus, a taxpayer entering into the equity swap described in footnote 8 in the report would not deduct any periodic payments made or include any periodic payments received, would not recognize gain or loss in respect of any nonperiodic or termination payment made or received, and would not recognize any gain or loss in respect of a sale, exchange, assignment, or termination of the swap.

31 We recognize that this expansion of section 1032 will result in distinctions that in some cases are largely formalistic. These include the distinction as between (i) a corporation that borrows to redeem its stock and (ii) a corporation that enters into a long equity swap with respect to its stock. In the first case, the corporation would be entitled to interest deductions, see section 162(k)(2)(A)(i), but in the second no deductions would be allowable. These distinctions also include the analogous distinction between (i) a corporation that issues stock and invests the proceeds and (ii) a corporation that enters into a short equity swap. These distinctions are consistent with the fact that the law does not recharacterize equity swaps as long or short positions in stock combined with borrowings or investments, respectively.

The proposed second sentence of section 1032(a) provides for nonrecognition of income, gain, loss or deduction "with respect to" the listed financial instruments in order to make clear that nonrecognition treatment applies regardless of whether the realization event occurs upon sale, exchange, settlement, or lapse, and regardless of whether the contract is settled in money, services, stock, or other property.[32] However, as under current law, a corporation would recognize gain or loss to the extent appreciated or depreciated property (other than the corporation's stock or some other financial instrument described in section 1032(a)) is used by the corporation to settle a financial instrument to which revised section 1032(a) applies.[33] Likewise, the revisions to section 1032(a) would not affect a corporation's deductions when stock is issued to an employee for services rendered or to a tax-exempt organization as a charitable contribution.[34]

It is intended (and the legislative history should so provide) that an option or forward contract would not fail to be described in the proposed second sentence of section 1032(a) because its exercise price is adjusted to take account of changes in interest rates or distributions on the corporation's stock.[35]

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32 As described below, we recommend that the first sentence of section 1032(a) be expanded to specifically include services, but we do not recommend a change to current law with respect to a corporation that issues its stock or an option on its stock to an employee that performs services.

33 For example, assume that a corporation has written a call option that permits its holder to purchase the corporation's stock. At a time when the value of the option is $25, the corporation repurchases the option with property (other than its stock) with a value of $25. In this example, the corporation would recognize gain or loss equal to the difference between $25 and its basis in the property, but would not recognize gain or loss with respect to the option.

34 See sections 83(h) and 404(a)(5) (compensation deduction); Revenue Ruling 75-348, 1975-2 C.B. 75 (corporation that pledges to sell its stock to a charitable organization is entitled to a charitable deduction upon exercise in an amount equal to the excess of the fair market value of the shares on the date of exercise over the exercise price).

35 The definition of options and forward contracts for purposes of section 1032 would also include options and forward contracts for which premium is paid in fixed installments or in installments that vary by reference to an interest rate, and options exercisable only on specific dates or on dates contingent on the price of the stock. However, no inference would be intended whether these financial instruments constitute options or forward contracts for other federal income tax purposes.

It is intended that the word "contract" as used in the second sentence of proposed section 1032(a) would be defined without regard to the fact that payments under it are within the control of, or unique to, the corporate taxpayer.[36] It is also intended that this change to section 1032(a) would not create any inferences with respect to the characterization of the contract (or the treatment of the corporate taxpayer's counterparty) for federal income tax purposes.

Our revisions to section 1032(a) would apply to notional principal contracts to the extent a leg provides for gross payments based on changes in value of the taxpayer's stock (including any dividends paid on the stock).[37] A notional principal contract would not, however, be treated as based on the value of a corporation's stock to any extent solely by reason of its settlement in the corporation's stock.

For example, a traditional interest rate swap that provides either counterparty with the option to settle its net obligations by delivering an amount of the taxpayer's stock equal in value to the payments the counterparty otherwise would be obligated to make would not be described in revised section 1032. Because the interest rate swap does not at all relate to the taxpayer's stock (other than providing that stock may be the currency for settlement), the interest rate swap would not be treated as two swaps each of which are described in section 1032(a). Similar principles would apply to analogous financial instruments.

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36 Regulations section 1.446-3(c)(1) requires that a notional principal contract provide for periodic payments calculated by reference to a specified index upon a notional principal amount. The definition of specified index includes an index that is based on "objective financial information," but the definition of objective financial information <u>excludes</u> information that is within the control of any of the parties to the contract or is unique to one of the parties' circumstances (such as one party's dividends, profits, or the value of its stock). Thus, the swap described in footnote 8 of this report does not constitute a notional principal contract under regulations section 1.446-3(c)(1). Our proposed changes to section 1032(a) would not affect the definition of notional principal contract contained in regulations section 1.446-3(c)(1).

37 The second sentence of proposed section 1032(a) refers to "distributions" rather than "dividends" so as to include a contract whose payments reflect distributions that may not be dividends for federal income tax purposes (because not out of earnings and profits).

As discussed below, authority is granted to the Treasury to promulgate regulations that would interpret the application of section 1032 to other complex swaps that reference a corporate taxpayer's stock. However, the regulations would not be necessary for the application of the proposed revisions.

It is not appropriate for all of the income, gain, loss, or deductions in respect of certain complex notional principal contracts and other financial instruments to be entitled (or subject) to nonrecognition treatment under section 1032. Moreover, for administrative reasons, it is not appropriate for contracts that relate to a corporation's stock by no more than a de minimis amount (e.g., a contract referencing a broad market index of which the corporation's stock is a component). Accordingly, under our proposed revision of section 1032(a), nonrecognition treatment would apply only to gain or loss "to the extent" attributable to the corporation's stock. Specific rules for determining the portion of such income, gain, loss, or deduction subject to section 1032 may be provided by regulations. However, we do not believe that regulations should be necessary in order for section 1032 to apply to a derivative that provides for payments determined in part--but not solely--by reference to a corporation's stock.

For example, proposed section 1032(a) would apply without the promulgation of regulations in the situation where ABC Corp. enters into an equity swap that provides for ABC Corp. to (i) make periodic payments equal to dividends paid on a fixed number of ABC Corp. shares, (ii) receive periodic payments based on any dividends paid on a fixed number of XYZ Corp. shares and, (iii) at maturity, receive (or pay) the relative change in value of XYZ Corp. over ABC Corp. This complex equity swap is economically similar to two equity swaps: (1) a "short" ABC Corp. equity swap (which, with respect to ABC Corp., would be described in proposed section 1032(a)) and (2) a "long" XYZ Corp. equity swap (which would not be so described). In this case, while the portion of ABC Corp.'s income, gain, loss, or deduction attributable to the component representing the short ABC Corp. equity swap would be entitled (or subject) to section 1032(a) nonrecognition treatment, the portion of ABC Corp.'s income, gain, loss, or deduction attributable to the component representing the long XYZ Corp. equity swap would not be entitled (or subject) to any nonrecognition treatment under section 1032.[38] We would anticipate (and the legislative history should provide) that this ABC Corp. v. XYZ Corp. swap would be treated as two separate notional principal contracts solely for purposes of section 1032, and that section 1032(a) would apply only to the ABC Corp. component.

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[38] Thus, the "to the extent" language generally would apply in all cases where one leg of the contract is based on the value of the taxpayer's stock and the other leg is based on the price of some other property (or other index). Cf. Treasury regulations section 1.246-5.

For reasons of administrability, we would anticipate (and the legislative history should provide) that the de minimis exception contained in section 1032(a) would apply (without the promulgation of regulations) if the specified index under the equity swap includes 20 or more stocks and the fair market value of the taxpayer's stock represents 10% or less of the fair market value of the stocks represented in the index,[39] determined using principles analogous to those under regulations section 1.246-5(c).[40]

For example, if a corporation is listed on the Dow Jones Industrial Index and enters into an equity swap based on changes in the value of the Dow Jones Industrial Index (or purchases or sells a futures or option on the Index), no portion of the taxpayer's income, gain, loss, or deduction would be treated as described in section 1032(a). However, if a corporation's stock represents more than 10% of an index under this test (i.e., it does not benefit from the de minimis carve-out in section 1032(a)), the swap would be split solely for purposes of section 1032 and only the portion of any income, gain, loss, or deduction attributable to the taxpayer's stock would be subject to section 1032.

B. Revised Section 1032(b) ("Cash-and-Carry Transactions").

New proposed section 1032(b) is designed to provide an exception from the expanded nonrecognition treatment under revised section 1032(a) and to tax a corporation if it repurchases its stock and, within 30 days before or after such repurchase, enters into a contract to sell its own stock under circumstances in which substantially all the corporation's expected return in respect of its net investment (i.e., the purchase price of the acquired stock) is attributable to the time value of the money.

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39 Section 1032 would not apply to a corporation entering into an equity swap (or a futures or options contract) with respect to an index unless its stock represents more than 10% of the index. This test should allow a corporation listed on any major stock index to enter into an equity swap with respect to the index without raising section 1032 issues. (The stock representing the greatest percentage by value of the Dow Jones Industrial Average on January 20, 1999 (IBM) was less than 10% (8.568%). Microsoft, which constitutes the largest component of the S&P 500 Index, represented 3.96% as of January 20, 1999.) These principles would apply with equal force to a forward, futures, or option contract with respect to an index.

40 The Treasury's regulatory authority under section 1032(c)(1) could be exercised (with retroactive effect) to prevent abuse. Cf. Treasury regulations section 1.246-5(c)(1)(iv).

As explained earlier in this report, although we do not support the Administration Proposal, we support a carve out of such transactions from section 1032. We believe that the economic equivalence of these transactions, on the one hand, and loans, on the other, is sufficiently compelling to provide an exception from the traditional nonrecognition treatment for a corporation that deals in its own stock. However, we do not believe that it is appropriate to change the settled tax treatment for a corporation that purchases or sells its stock without any principal purpose to achieve a tax-free time value of money return. Under the proposal, the corporation would be taxable under a constant yield method over the term of the forward contract on the difference between the stock sales price and the acquisition price of the repurchased stock.

Although proposed section 1032(b) has a potentially broad scope and may apply to a corporation that purchases stock within a full 30-day period before or after entering into a contract to sell its stock, section 1032(b) would not apply to a corporation that for non-tax reasons engages in both legs of a transaction otherwise described in section 1032(b).

> **Example (1).** A corporation has in place a stock buyback program that was implemented two years ago because the corporation's Treasury function believed that its stock was undervalued in the marketplace. Pursuant to the program, the corporation periodically repurchases its stock. On June 1, pursuant to the program and without any plan to sell its stock forward, the corporation repurchases 100 shares of its stock. On June 3, as a result of market, industry or other factors (which may or may not affect the trading price of the corporation's stock), the corporation determines that its stock is overvalued and enters into a contract with a counterparty to sell 100 shares of its stock in one year. Although certain of the corporation's employees are aware that, if proposed section 1032(b) does not apply to the transaction, all or a portion of the corporation's net return in respect of the repurchase and the forward sale will represent a tax-free interest equivalent, these employees did not propose either the repurchase or the forward sale for this purpose. The corporation does not enter into any other transactions with respect to its stock until after the forward sale is settled.

Under these facts, the corporation would not be subject to section 1032(b), even if substantially all of its net return in respect of the repurchase and the forward sale are attributable to the time value of the corporation's net investment. In this example, the corporation could demonstrate that no principal purpose of the acquisition or forward sale was to achieve a tax-free return.

> **Example (2).** At a time when a corporation's Treasury function believed that the corporation's stock was undervalued, the corporation instituted a long-term stock buyback program. At the present time, however, the corporation's Treasury function does not believe that the stock is undervalued. A financial institution approaches the corporation and proposes a transaction in which the corporation would repurchase its stock pursuant to its buyback program and within 15 days enter into a derivative transaction with the financial institution that would obligate the corporation to make payments based on any appreciation in the value of the corporation's stock and entitle the corporation to receive payments based on any depreciation in the value of its stock. Substantially all of the corporation's expected return in respect of the transaction would be attributable to the time value of the corporation's net investment. The financial institution describes the benefits of the transaction as including favorable financial reporting treatment and a tax-free return. Both of these benefits are presented to and considered by the corporation's management, and the transaction is authorized.

Under these facts, the corporation would be subject to proposed section 1032(b). Although the corporation had non-tax reasons for engaging in the transaction (favorable financial accounting treatment), substantially all of the corporation's expected return is attributable to the time value of the corporation's net investment and one of the benefits of the transaction presented to and considered by management was the tax-free nature of the corporation's return.

C. Revised Section 1032(c).

New proposed section 1032(c) is designed to grant the Treasury sufficient regulatory authority to (1) interpret the application of section 1032 to complex financial instruments, (2) deny section 1032(a) nonrecognition treatment to financial instruments that would otherwise be described in section 1032(a) but which are part of a straddle or other integrated transaction not properly described in section 1032(a), (3) apply section 1032(a) to debt instruments, (4) apply section 1032(a) to interests in partnerships and trusts holding positions in the taxpayer's stock and to new financial instruments, in each case consistent with the purposes of section 1032, and (5) address certain issues that would under proposed section 1032(b).

Although, as described in Part III.A., the "to the extent" language would be self-executing without the promulgation of regulations, section 1032(c)(1), is designed to specifically authorize regulations interpreting this phrase for complex financial instruments.

Section 1032(c)(2) is intended to grant the Treasury regulatory authority to address the converse situation where a financial instrument is described in section 1032(a) but is part of an integrated transaction that would not be described in section 1032(a) if it constituted a single financial instrument. For example, assume a taxpayer enters into two equity swaps on its own stock, one of which provides that the taxpayer will make fixed payments and receive any appreciation (and pay any depreciation) on its stock and the other of which provides that the taxpayer will receive floating interest-rate payments and pay any appreciation (and receive any depreciation) on its stock. Revised section 1032(b)(2) is intended to give the Treasury authority to treat these two swaps solely for purposes of section 1032 as a single swap that is not described in section 1032.[41]

Proposed section 1032(c)(3) would grant the Treasury regulatory authority to apply section 1032 to interest income and expense on debt instruments. For a debt instrument that provides for noncontingent interest and principal, plus contingent interest determined solely by reference to the value of stock of the issuer or holder, it is anticipated that these regulations would treat the amount of any net positive or net negative adjustment (as defined under regulations section 1.1275-4(b)(6)) in respect of the debt instrument as subject to section 1032(a).[42]

Proposed section 1032(c)(4) would grant the Treasury regulatory authority to extend (or restrict) the scope of section 1032 to address taxpayers that own interests in partnerships and trusts with financial instruments subject to section 1032, financial instruments not specifically described in section 1032(a), and new financial products. It is also anticipated

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41 Cf. Treasury regulations section 1.446-3(g).

42 For example, assume that ABC Corp. purchases a contingent payment debt instrument issued by an unrelated party that provides for interest based on the value of ABC Corp. stock. In this case, ABC Corp. would include in income interest income based on its (continued...)

that if future law were to change with respect to the generally applicable treatment of financial instruments, the Treasury would have the regulatory authority to conform nonrecognition treatment under section 1032 appropriately.[43]

Proposed section 1032(c)(5) would grant the Treasury regulatory authority to apply section 1032(b) in situations where the purchase price for the stock purchased or the sales price for the stock sold is paid or received in two or more installments, and where the two legs relate to different amounts of stock.

Finally, we have suggested an amendment to the first sentence of section 1032(a) in order to confirm and clarify that section 1032 applies to stock issued for services. Regulations currently in effect so provide.[44]

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counterparty's comparable yield, but would not report gain or loss in respect of any positive or negative adjustments.

43 For example, certain commentators have suggested that taxpayers should accrue current income or expense under financial instruments that are not treated as debt for federal income tax purposes but nevertheless contain time value of money components (including, for example, "prepaid forwards" and options). See, e.g., Noël B. Cunningham & Deborah H. Schenk, "Taxation Without Realization: A Revolutionary Approach to Ownership," 47 Tax L. Rev. 725, 735, 775-792 (1992). In the event that premium or other prepayments under financial instruments are subject under future law to current time value of money accruals, it may not be appropriate to exempt a corporation from this treatment on an option (or prepaid forward contract) with respect to its stock. The legislative history to section 1032 might expressly refer to this authority without reflecting a view as to the treatment under current or future law of financial instruments.

44 Treasury regulations section 1.1032-1(a). A corporation would as under current law be entitled to an ordinary deduction equal to the value of any stock issued for services rendered.