Tax Report #990

Timing And Character Rules For Prepaid Forwards And Options:

A Report of the New York State Bar Association Tax Section*

* The principal drafter of this report was David M. Schizer. Helpful comments were received from Samuel Dimon, Michael Farber, Robert A. Jacobs, Kent Killelea, Erika Nijenhuis, Robert H. Scarborough, and Michael Schler.

This report discusses possible changes to the timing and character rules for prepaid forwards and options. The Treasury Department has expressed its interest in studying and refining these rules.[1] 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).[2]

Part I summarizes the problem and our recommendations. Part II offers three recommendations. As under the contingent debt regulations of Treas. Reg. § 1.1275-4, interest should accrue at an assumed yield prior to realization. Upon a realization event, gain or loss should be recognized to remedy disparities between the assumed and actual yields (so-called "adjustments"). Yet, unlike the contingent debt regulations, the character of adjustments should be capital, not ordinary, and physical settlement should not trigger an adjustment for the purchaser. Part III evaluates three alternatives to our recommendations: preserving current law; extending the contingent debt regulations without modification; and adopting mark-to-market accounting for prepaid forwards and options. We discuss the effect of each recommendation or alternative on the system's accuracy, complexity and consistency. We also consider the need or desirability of legislation to enact these recommendations for regulatory implementation.

I. SUMMARY

Because parties that prepay are rewarded for parting with use of their money, we recommend imputing interest on (i) prepaid forwards (ii) deep-in-the-money options and (iii) long-dated options.

---

1 See T.D. 8491, 58 Fed. Reg. 53125, 53127 (Oct. 14, 1993).

2 While prepayments and options relating to other goods and services present similar theoretical issues, they are not considered here because opportunities for tax-motivated transactions are likely to be more limited and administrability concerns may prove more weighty. For a discussion of other prepayments, *see* Robert H. Scarborough, *Payments in Advance of Performance*, 69 Taxes 798 (Dec. 1991).

This interest imputation step 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 uncertain. We believe this proposal could be implemented through regulations, although the requisite regulatory authority is not entirely free from doubt, and might be confirmed by legislation.

Whereas the contingent debt regulations also impute interest, we would diverge from that 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 also 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 avoiding any 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 analyze three alternative regimes. Current law is simpler than our proposal but fails to account accurately for the time value associated with prepayments. Extending 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.

II. PROPOSED TIMING AND CHARACTER RULES

We offer three recommendations. First, income and deductions, based on an assumed yield, should accrue prior to realization for designated prepaid forwards and options. Second, unlike the contingent debt regulations, the character of adjustments should be capital instead of ordinary. Third,

also unlike the contingent debt regulations, physical settlements should not trigger adjustments for the purchaser.

A. Accruals Prior to Realization

1. Description

Under current law governing prepaid forwards and options, tax consequences generally are deferred until a realization event,[3] while the contingent debt regulations impute income and deductions prior to realization. We recommend similar imputations should apply to designated prepaid forwards and options. Under our recommendation, an assumed yield would generate interest income for the party making the initial payment (*e.g.*, the buyer of a prepaid forward contract and the holder of an option) and interest expense for the party receiving the payment. The accrual would be ordinary in character and treated as interest for all purposes of the Code, including the investment interest rules, capitalization regime under Section 263(g), eligibility for portfolio interest treatment for foreigner investors, and the like.[4] The amount accrued would be based on the "comparable yield" of the party receiving the payment: the seller of a prepaid forward, or the grantor of a put or call option.[5] If a securities dealer is the counterparty, the dealer should be required to determine the

---

[3] Thus, receipt of a premium on an option usually is not treated as income under current law. Gain or loss generally is recognized when the option is sold, lapses, or is settled in cash (*i.e.*, when the parties exchange cash payments to settle their obligations). Physical settlement of an option causes the party delivering the property (the holder of a put or grantor of a call) to recognize gain or loss. *See, e.g.*, Rev. Rul. 78-182, 1978-1 C.B. 265. Although there is no clear authority for the treatment of prepaid forwards under current law, it generally is believed that sellers who receive a prepayment on a prepaid forward do not have income as long as the prepaid forward is not viewed as a sale or a constructive sale. Cash settlement of a prepaid forward creates tax consequences for both the buyer and seller. Physical settlement is a realization event for the seller, but not for the buyer, who is treated as purchasing property. *See* the Appendix for examples. For further discussion, *see* Lewis R. Steinberg, *Using OTC Equity Derivatives for High-Net-Worth Individuals*, *reprinted in* The Use of Derivatives in Tax Planning (Frank J. Fabozzi ed. 1998).

[4] In this regard, the regime we propose would track the treatment in the contingent debt and swap regulations. *See* Treas. Reg. § 1.1275-4(e); Treas. Reg. § 1.446-3(g)(4).

[5] For example, assume a buyer enters into a prepaid forward contract to purchase stock that is currently worth $100 and does not pay dividends. The buyer pays $100 currently and will receive delivery of the stock in three years. Assuming

comparable yield and to report this amount to the counterparty and the I.R.S. Otherwise, this responsibility should lie with the party receiving the payment. Both parties to the forward contract or option should be required to use the same comparable yield.

Our proposal would not apply to transactions subject to Section 1032 or mark-to-market accounting under Section 1256 or Section 475. As discussed below, we also recommend exceptions for forwards with only modest prepayments or options that are short-term or not deep-in-the-money.

2. Accuracy

Pre-realization accruals would enhance the tax system's accuracy. When prepaying, investors forgo use of their money.[6] Our understanding is that investors typically are rewarded for their prepayments through instrument pricing. For instance, the purchase price in a prepaid forward typically is lower than in a nonprepaid forward, and this differential represents compensation for time value. While this interest-type compensation will be offset or supplemented by risk-based returns in some cases, the time-value component is expected to yield, on average, positive returns at least equal to the risk-free rate.[7] Yet, realization accounting effectively assumes *no* return until a realization event occurs. Thus, this rule can be expected to understate the prepaying party's income and overstate the counterparty's income.[8] This mismeasurement was well understood in the context of

---

the seller's usual borrowing cost is $10, the buyer would have $10 of interest income in the first year, $11 in the second year, and $12.10 in the third, and the seller would have corresponding interest expense.

6 *See* David Hariton, *The Accrual of Interest on Derivative Investments: Where Do We Go From Here?* 74 Taxes 1011 (1996) ("[S]ince there is no such thing as a free lunch, the corporation presumably compensates the investor in some way for the use of these funds"); *see also* Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 Yale L. J. 506 (1986). Cf. Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 Harv. L. Rev. 460 (1993) (discussing put-call parity theory and idea that share of stock is equivalent to a long call, a short put, and a bond).

7 *See* Reed Shuldiner, *A* General *Approach to the Taxation of Financial Instruments*, 71 Tex. L. Rev. 243 (1992).

8 If both parties are subject to the same tax rate and timing rules, they presumably would adjust pretax prices to account

contingent debt. The same solution, pre-realization accruals, would address the inaccuracy in this context as well.

Admittedly, pre-realization accruals do not remedy an important source of inaccuracy in current law: mismeasurement of risk-based returns. Even if risk-based losses are as likely as gains, current law tends to understate income because gains are more likely to be deferred than losses. This "timing option" would persist under our proposed regime. Taxpayers who underperform the assumed yield presumably would be more likely to sell than those who outperform this yield.[9] The timing option would be constrained, to a degree, by loss limitation rules (*e.g.*, Sections 1091, 1092, 1211) and transaction costs.[10]

3. Complexity

Our proposal is more complex than realization accounting because taxpayers would have to compute pre-realization income and deductions. In addition, some taxpayers would have income before receiving any cash or property. Nevertheless, similar computational and liquidity burdens have

---

for the mismeasurement. But in many cases, parties are subject to different rules. For instance, securities dealers, the counterparty in the over-the-counter market, generally are subject to mark-to-market accounting under Section 475.

[9] *See* Jeff Strnad, *The Taxation of Bonds: The Tax Trading Dimension*, 81 Va. L. Rev. 47 (1995); Mark Gergen, *The Effects of Price Volatility and Strategic Trading Under Realization, Expected Return, and Retrospective Taxation*, 49 Tax L. Rev. 209 (1994).

[10] For instance, the seller could have to deliver the property prior to maturity – a step that could raise securities law issues (*e.g.*, for restricted stock). If the seller cash settles the contract instead, this step could trigger a liquidity problem. In addition, sometimes a party could not accelerate losses without causing his counterparty to recognize gain prematurely. If the two parties were subject to the same tax rates and timing rules, this "symmetry" could prompt contractual terms that prevent taxpayers from using the timing option. In many cases, though, counterparties will not be subject to the same tax rules. If the counterparty is tax-exempt or foreign, it would not object to premature settlement of a contract at a gain. Likewise, because securities dealers mark most positions to market, premature settlement would not affect their tax liability, so they might accept a premature termination to enable a customer to trigger a tax loss. *See* Edward D. Kleinbard & Thomas L. Evans, *The Role of Mark-to-Market Accounting in a Realization-Based Tax System*, 75 Taxes 788, 796 (December 1997).

proved manageable under the original issue discount and contingent debt rules. Nor would there be need for potentially difficult valuations because the regime would rely on an assumed yield.

Even so, these extra administrative burdens arguably would not be justified for all prepaid forwards and options. A key question is when these costs exceed the accuracy-related benefits of pre-realization accruals. These benefits are less substantial for options and forwards with relatively short terms and small prepayments. The time-value return, and deferral of tax accounting for it, are less significant. Accordingly, there is a strong argument for retaining traditional accounting for instruments with sufficiently short terms or modest prepayments. This argument is reinforced by the long history of realization accounting for these instruments, especially options, as well as by our sense that "conventional" options and forwards are often used in transactions not motivated by the tax system's mismeasurement of time value. There also is precedent for preserving realization accounting for a subset of instruments. The contingent debt regulations do not apply to enumerated short-term instruments,[11] and the swap rules distinguish between significant and non-significant nonperiodic payments.[12]

Because the objective of preserving realization accounting for some instruments is to spare them from more complex rules, it would be counterproductive to impose a complex threshold test for determining whether the simple rule is available. Unfortunately, a simple distinction is likely to be somewhat arbitrary, treating similar transactions differently. To mitigate this concern, an anti-abuse rule might be added for arrangements designed to attain results inconsistent with the purposes of the regulations. Likewise, the straddle rules should deter taxpayers from, for instance, purchasing

---

[11] *See* Treas. Reg. § 1.1275-4(a)(2)(vi) (exception for instruments with fixed maturity date not more than 1 year after issue date).

[12] *See* Treas. Reg. § 1.446-3(g)(4)(bifurcating swaps with significant nonperiodic payments into loan and on-market, level payment swap).

a call with traditional treatment and hedging with a short call that is just different enough to generate an imputed deduction. To prevent this tax arbitrage, it must be made clear the imputed deduction under this regime would be deferred under the straddle rules.[13]

Our Executive Committee members reached no clear consensus as to precisely where to draw the line. For forwards, the key could be the ratio of the prepayment to the present value of the total purchase price.[14] The discount rate for this present value computation should be the comparable yield. Alternatively, the ratio could compare the prepayment to the fair market value of the underlying property when the parties enter into the contract. Under either approach, if this ratio exceeds some maximum fraction (*e.g.*, 1/5), the regime would apply, regardless of how long the term of the forward is.[15] This rule becomes more difficult to apply if the purchase price (or the amount

---

[13] Because this imputed return resembles interest, it should be governed by Section 263(g), rather than Section 1092. For recommendations concerning the straddle rules, see New York State Bar Association Tax Section, Comments *on Proposed Straddle Legislation*, *reprinted in* 87 Tax Notes 823 (May 8, 2000). For instance, we have recommended that short calls should be straddles with stock only if the call is sufficiently risk-reducing. This condition is likely satisfied by short calls that are eligible under our proposal for imputed deductions, as the short calls would need to be long-dated or deep-in-the-money.

Under recently-proposed Section 263(g) regulations, imputed interest expense on a short call or prepaid forward would be capitalized into an offsetting long (*e.g.*, stock or a long-call). While there are several bases for this conclusion, the most straightforward is that the regulations capitalize "otherwise deductible payments or accruals on financial instruments that are part of a straddle or that carry part of a straddle." *See* Prop. Treas. Reg. § 1.263(g)-3(b)(3). This expansive language would seem to cover accruals on prepaid forwards or options that are part of a straddle.

[14] Thus, a typical mandatorily exchangeable security would not be eligible for the safe harbor (assuming it was not bifurcated). The holder would pay, say, $100 to purchase the security, and no further payments by the holder would be required. Thus 100% of the total purchase price would be paid up front, triggering the regime. (Note that the coupon payments to be received by the holder do not figure into this calculation.) As noted below, the imputation regime would not apply if the mandatorily exchangeable security were treated, under a bifurcation approach, as an interest-bearing bond or deposit and a nonprepaid forward contract. The tax consequences of this bifurcation approach would be comparable to those of the imputation regime, however, provided that (i) interest accruals on the deposit are based on the comparable yield and (ii) adjustments under the imputation regime are treated as capital, as we recommend. For a discussion, see the Appendix.

[15] This mechanic applies most sensibly if the prepayment occurs when the parties enter into the forward. What if, instead, the prepayment is made a year later? The ratio could be computed when the prepayment is actually made, because that is when an imputed yield would begin. Alternatively, the payment could be discounted back to its value at inception, as under the swap rules. *See* Treas. Reg. § 1.446-3f(2)(iii)(B) ("Nonperiodic payments on a swap other than an up-front payment may be amortized by treating the contract as if it provided for a single up-front payment (equal to the present value of the nonperiodic payments) and a loan between the parties.").

of property to be delivered) is subject to contingencies, and thus cannot be computed in advance with certainty. One approach is to use the minimum purchase price (or the minimum amount of property that may be delivered). This rule would make eligibility for traditional accounting more difficult. The theory would be that the comparable yield approach presumptively applies and an exception is made only for clear cases. In addition, a separate exception should also be considered for prepayments that precede performance by one year or less, regardless of how much is prepaid.

For options, a test based on the proportion of the option premium to the present value of the purchase price is less viable, because the option premium is based to a greater extent on the volatility of the underlying property.[16] As a result, taxpayers might be able to opt in and out of the safe harbor based on their assessments of volatility, which could prove subjective. Instead, the test could be based on a combination of two factors: how deep in the money the option is and how long is the term to maturity. For call options, for instance, the traditional regime could be applicable if the strike price is at least 75% of the spot price when the option is purchased and the term to maturity is two years or less.[17] This safe harbor is broader than the one for prepaid forwards. The distinction is justified because the treatment of options is more well established and because options have a history of extensive use unrelated to the tax system's inaccurate treatment of time value; in contrast, the tax treatment and business uses of prepaid forwards are less well established. Thus, the goal here is to exclude standardized exchange-traded options, as well as economically equivalent arrangements

[16] Forwards containing "optionality" also present this problem to a degree.

[17] Alternatively, the minimum strike price to avoid the regime might increase with the number of years to maturity on the option: for instance, the hurdle might be 75% of the spot price, increased by the comparable yield of the option writer for each year of the option's term. For instance, if 75% of the fair market value is $100, the relevant rate is 5%, and the option's term is four years, traditional accounting would apply to any option with an exercise price above $121.55.

offered over-the-counter.[18] So-called LEAPS and FLEX options (*i.e.*, more tailored options offered on exchanges) would also qualify for the safe harbor if they satisfied the relevant standard.

4. Inconsistency and Planning

Our proposal's effect on consistency is uncertain. Unless options and prepaid forwards are taxed in the same manner as close substitutes, taxpayers will engage in wasteful planning to exploit that inconsistency. Resources will be misallocated, revenue will decline, and well-advised taxpayers will fare better than those who do not secure competent advice. Although consistency is desirable, it cannot be attained through piecemeal reform because current law already employs several competing treatments for similar financial transactions.[19]

Under our proposal, timing rules for prepaid forwards and long-dated options would be largely consistent with timing rules for contingent debt (except for physical settlements, as discussed below). Similar timing rules also apply to a fixed-rate bond or deposit paired with a nonprepaid forward contract, which is the conventional tax characterization adopted in marketing of mandatorily exchangeable securities.[20] While the nonprepaid forward contract[21] does not generate pre-realization accruals, the deposit does. To ensure these arrangements are taxed consistently with the treatment of prepaid forwards under our proposal, interest on the deposit must accrue based on the borrower's

---

[18] The standard here is analogous to the one for qualified covered call options under the straddle rules, although the safe harbor would not be limited to exchange-traded options.

[19] *See* Robert H. Scarborough, *Different Rules for Different Players and Products: The Patchwork Taxation of Derivatives*, 72 Taxes 1031 (1994).

[20] For illustration of the point that our proposal aligns the treatment of prepaid forward contracts and mandatorily exchangeable securities, *see* Appendix Part IV.B.2.

[21] The nonprepaid forward contract, by itself, should be compared to a pair of options. For instance, a "long" forward position is economically comparable to a long call paired with a short put having the same exercise price. Under our proposal, there would be no accrual on the forward. On plausible assumptions, the same result is reached for the pair of options. Accrued gain on the long call would be offset by accrued loss on the put, assuming the comparable yields of the two option counterparties were the same and an anti-abuse rule, such as the straddle rules, did not limit the loss.

comparable yield (*i.e.*, under the original issue discount rules), and not based on the cash coupon paid.[22]

The same timing rule arguably governs a loan paired with a "bullet" swap,[23] although this conclusion turns on one's interpretation of current law with respect to bullet swaps. In bullet swaps, the "long" counterparty makes a periodic interest-based payment every year, and at maturity the parties settle their risk-based bet on the underlying property.[24] The treatment of a bullet swap paired with a loan resembles our proposal as long as tax consequences on the interest-based swap payments are deferred until maturity. Under this rule, which some Executive Committee members consider to be current law for bullet swaps, and which we have proposed (along with other alternatives) in a prior report, the swap itself would generate no interest-based expense for the "long" counterparty prior to maturity.[25] On the paired loan, the "long" would have pre-realization *income* (and the short would have corresponding deductions), a result that resembles our proposal for prepaid forwards.[26] On the other hand, if the interest-based swap payments *do* generate deductions for the "long" and income for the "short" prior to maturity – a reading of current law accepted by other members – these

---

[22] We understand that under current law some issuers of mandatorily exchangeable securities base accruals on the cash coupon. The Treasury Department should clarify that the cash coupon is not the right standard.

[23] The same question arises for prepaid bullet swaps because they are bifurcated into nonprepaid swaps and loans as long as the prepayment qualifies as a "significant" nonperiodic payment. *See* Treas. Reg. § 1.446-3(g)(4).

[24] For instance, assume the S&P 500 Stock Index is the underlying property, currently worth $1300. At maturity, the "short" would pay the amount by which the S&P 500 exceeds $1300 or the "long" would pay the amount by which the index declines below $1300.

[25] Periodic payments generally are taken into account during the taxable years in which the periodic payment accrues. However, this result is uneconomic if only one party makes periodic payments, which payments, in effect, are purchasing an expected payment at maturity. For a discussion, see New York State Bar Association Tax Section, *Report on Notional Principal Contract Character and Timing Issues*, *reprinted in* 98 Tax Notes Today 104-78 (June 1, 1998).

[26] The degree of resemblance also depends on character. As discussed below, we recommend capital character for adjustments. Risk-based payments on a swap will also be capital in character if the swap is terminated prior to maturity. *See* Section 1234A. Yet, if the "bullet" swap terminates at maturity, there is disagreement among our members about the character of the final swap payment.

consequences would offset the accrual of interest on the loan. As a result, the swap and loan, in combination, would no longer generate interest or deductions prior to maturity, a result that diverges from our recommendation.

The starkest inconsistency inherent in our proposal is the timing rule for underlying property. Even if the comparable yield approach is ultimately applied to all derivatives, common stock is likely to remain on traditional accounting, if only because of the political difficulties of using an unfamiliar tax rule for such a traditional investment.[27] Another inconsistency is the application of mark-to-market accounting to certain options and futures contracts under Section 1256. These inconsistencies are not surprising, because "so long as we continue under a realization system of tax accounting, it is not possible to achieve an equivalent tax treatment of economically equivalent financial investments."[28]

A key question is our proposal's effect on planning. Our proposal would make it more difficult for tax sensitive investors to avoid current accruals. Not only contingent debt, but also close substitutes — prepaid forwards and long-dated or deep-in-the-money options — would generate accruals. Accruals would remain available by holding the underlying property.[29] A separate source of planning-related waste is the effort to *qualify* for the accrual regime, *i.e.*, to generate imputed deductions. Under our proposal, taxpayers could replace short sales with short prepaid forward

---

[27] Our members offered two substantive justifications for retaining realization accounting for the underlying property -- and, in particular, corporate equity -- even if derivatives are subject to accrual. First, realization reduces the tax burden on shareholders, which arguably is justified in light of the double tax on corporate equity. Second, with respect to stock, as opposed to a derivative, there is no counterparty that could claim offsetting deductions if imputation of income were required on the "long" position.

[28] Hariton, *supra* note 7, at 1012.

[29] *See* David A. Weisbach, *Reconsidering the Accrual of Interest Income*, Taxes, Mar. 2000, at 36 (key question is elasticity of taxpayer demand for underlying property compared to derivatives).

contracts that generate interest expense.[30] It would be unfortunate if our proposal never required anyone to have imputed income (*i.e.*, because only tax-indifferent parties made prepayments subject to the accrual regime) while offering a new source of tax arbitrage (*i.e.*, as tax-sensitive investors claimed imputed deductions while hedging with positions not subject to our proposal). That arbitrage generally would be thwarted by recently proposed regulations under Section 263(g), which capitalize the imputed deductions.[31]

5. Regulatory Authority

We believe this proposal can be implemented through regulations, although regulatory authority is not entirely free from doubt. If regulations are adopted, the applied principles might be confirmed by legislation. This approach is similar to one taken with the hedging regulations under Section 1221, which were subsequently confirmed by statute. For our proposal, current law offers two potential sources of authority.[32]

---

[30] Admittedly, the counterparty would have imputed income on the prepaid forward contract, but would not on a short sale. Yet, this imputed income would not affect a counterparty that marks to market, as do securities dealers, which are the most likely counterparties: character is ordinary regardless, and the imputed income inclusion will be overridden each year when the dealer marks the position to market.

[31] One potentially overbroad application of Section 263(g) warrants consideration, though. If a taxpayer receives a payment on a prepaid forward to sell property, and hedges through a nonprepaid forward to *buy* the same property in the future, the two positions net, in effect, to a fixed-rate borrowing. For instance, assume the taxpayer enters into a prepaid forward to sell in two years an amount of stock that varies with the stock price, and receives $100 currently. At the same time, the taxpayer hedges by entering into a nonprepaid forward contract to buy the same property for $121 in two years. On a net basis, the taxpayer receives $100 now and will pay $121 in two years. A deduction for interest expense, as provided by our proposal, is consistent with the economics. As a result, it arguably is not appropriate to capitalize this interest expense under Section 263(g) as a *per se* matter, even though the prepaid forward and hedge are offsetting. In an analogous circumstance, the contingent debt rules avert capitalization through an integration rule. *See* Treas. Reg. § 1.1275-6 (f) ("An integrated transaction is generally treated as a single transaction by the taxpayer" and so the component transactions are not "subject to the rules that would apply on a separate basis" to the components, "including section 1092 or § 1.446-4"). But this rule is not available for the many prepaid forwards that do not qualify as indebtedness. *See* Treas. Reg. § 1.1275-6(a) & (b) (providing for integration of "qualifying debt instrument"). If the government is interested in adopting an integration rule in connection with our proposal, we would welcome the opportunity to comment further.

[32] Note that the regulatory authority for contingent debt, clearly stated in Section 1275(d), does not apply here because it extends only to debt instruments.

First, Section 7872 authorizes imputation of interest for certain below-market loans. The legislative history describes Section 7872's scope with very broad language: "It is intended that the term 'loan' be interpreted broadly in light of the purposes of the provision. Thus, any transfer of money that provides the transferor with a right to repayment may be a loan. For example, advances or deposits of all kinds may be treated as loans."[33] Even so, it is not clear that Section 7872 can impute interest on instruments that are not "loans" for tax purposes. Indeed, when Congress revisited Section 7872 to make relatively minor modifications, the Senate Report indicated: "The Committee understands that the below-market loan provisions of the Code prescribe the treatment only of transactions that are loans for Federal income tax purposes, and that such provisions do not define and did not alter prior law relating to what transactions are or are not to be treated as loans."[34] If Section 7872 enables imputation on prepaid forwards and options, that imputation presumably would have to be at the applicable federal rate.[35]

Section 446 provides a possible alternative source of regulatory authority, if the imputation of interest can be viewed as an accounting method. Treas. Reg. § 1.446-3 provides precedent for this view by imputing imputes interest on the "loan" element of certain swaps. A caveat, though, is that Section 446 can be applied to determine the *timing* of income, but not to create income where none

---

[33] The full discussion is as follows:

> *Loans subject to the provisions*. The conference agreement generally applies to term or demand below-market loans that are gift loans, compensation-related loans, corporation-shareholder loans, and tax-avoidance loans. In addition, under regulations, the conference agreement applies to other transactions that are, in substance, below-market loans if the interest arrangements have a significant effect on the tax liability of either the borrower or the lender. It is intended that the term "loan" be interpreted broadly in light of the purposes of the provision. Thus, any transfer of money that provides the transferor with a right to repayment may be a loan. For example, advances or deposits of all kinds may be treated as loans. Conference Rep., P.L. 98-369, *reprinted in* CCH Standard Federal Tax Reports, at 73,749.

[34] *See* S. Rep. 99-83, 99th Cong. 1st Sess. 23 (June 13, 1985).

[35] *See* Section 7872(e) & (f).

would otherwise exist.[36] Does imputation of income on a forward create income where none otherwise exists? The argument that income is created would be that a buyer who physically settles a forward or call option would not have income — at least on the forward or option itself — absent imputation. Yet, this argument no longer holds if we also consider potential income or gain from selling the forward or option, or from selling the underlying property acquired through these contracts. Imputation of income on a forward or call option would lead to a higher basis in this contract, as well as in any property received through physical settlement. As a result, a sale would yield less gain (or greater loss).[37]

B. Character of Adjustments

1. Description

Under our proposal, as under the contingent debt rules, pre-realization accruals would be based on an assumed return, not market conditions. Because the assumption would not always prove to be accurate, an adjustment mechanism would be needed.[38] Under the contingent debt rules, those adjustments generally would be ordinary in character.[39] By contrast, we propose all adjustments on

---

[36] *See* Rev. Proc. 99-49, 1999-2 C.B. 725 ("In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income."); *see also Florida Progress Corp v. Commissioner*, 115 T.C. 36 (2000).

[37] This argument is analogous to the position that capitalization of expenses is a method of accounting. The government has taken this view of capitalization, thus requiring consent to switch from deducting to capitalizing certain expenses. *See, e.g.*, Rev. Rul. 90-38, 1990-1 C.B. 57 (capitalization of interest and carrying charges is a method of accounting, and thus cannot be modified retroactively without consent); Rev. Rul. 71-137, 1991-1 C.B. 104 (change from current deduction of football player contract acquisition costs to capitalization and depreciation of those costs is a change of accounting method); Prv. Ltr. Rul. 9746002 (Aug. 1, 1997) (change from capitalizing to deducting research expenses for purposes of AMT was a change in accounting method requiring IRS consent).

[38] For instance, the buyer of a prepaid forward contract might pay $100 and then include 10% a year of imputed interest income for two years. If the property is worth more than $121 when the forward is cash settled (*e.g.*, $150), the buyer should include and the seller should deduct an additional $29 of gain or loss.

[39] Specifically, if the return exceeds expectations, holders have additional ordinary income and issuers have additional ordinary losses. If the return underperforms the assumed yield, holders' losses are ordinary loss to the extent of prior ordinary inclusions and capital for the balance, while issuers have ordinary income.

prepaid forwards and long-dated options should be capital. We also recommend the Treasury Department consider converting a conforming change in the contingent debt regulations or, alternatively, provide clear guidance for distinguishing contingent debt from prepaid forwards and other economically similar instruments.

2. Accuracy

While the theoretical distinction between ordinary income and capital gain is not always clear generally, a common dividing line is that time-value returns are ordinary and returns from risk and market fluctuation are capital. Consistent with this pattern, the assumed time-value yield should be ordinary. Adjustments attributable to risk-based returns, such as the performance of the underlying property, should be capital.[40]

In some cases, taxpayers would be confronted with character mismatches. For instance, the buyer of a prepaid forward contract would have ordinary imputed income. Yet if the forward underperforms this imputed yield, the offsetting loss would be capital. This result can be defended on two grounds. First, as an economic matter, a prepaid forward contract might produce positive

[40] Relatedly, we would allow taxpayers to attain the long-term capital gains holding period for short positions, including written options, to the same extent as for long positions. This recommendation diverges from current law prescribing gain from *granting* an option is always short-term even if the grantor is not hedging and the option's term is longer than one year. *See* Section 1234(b). The rationale for short-term treatment presumably is that holding period should apply only to things that are "held" – that is, only for positions that are assets, not liabilities. Thus, the holding period on a short sale is based on the holding period of the property used to settle the short sale, and not on the length of time the short sale is outstanding. *See* Section 1233(b). However, this rationale is not consistently applied, especially for positions that could potentially be *either* an asset *or* a liability. For instance, a short position through an over-the-counter swap or cash-settled nonprepaid forward contract can generate long-term capital gain if the underlying asset would be a capital asset in the hands of the taxpayer, *see* Section 1234A, although a short position on a publicly-traded securities future can yield only short-term gain. *See* 1234B(b). Moreover, if the rationale for the holding period rules is to encourage taxpayers to accept risk, then "short" risk arguably is as socially valuable as "long" risk. Indeed, short sales and short option positions increase market liquidity, help market prices incorporate information, and serve to discourage speculative bubbles. Arguably, then, a "short" call (and, for that matter, a short sale) should be viewed as a "bet," just like a "long" call or a nonprepaid forward, and thus should be subject to the same character rule. For a discussion, as well as citations treating sale of stock on a "when issued" basis as long-term, see New York State Bar Association Tax Section, *Comments on H.R. 3170*, *reprinted in* 98 TNT 136-38 (July 14, 1998)

(ordinary) time-value return offset by a negative (capital) risk-based return. Second, the same result would have eventuated if the taxpayer had entered into a fixed-rate original issue discount ("OID") bond and a nonprepaid forward contract. On balance, we do not view the character mismatch that can occur under the imputation regime as problematic. We note, however, that the Treasury Department could provide a rule where any losses would be ordinary to the extent of prior ordinary income inclusions, and capital for the balance.

3. Complexity

Treating adjustments as capital could add complexity in two respects, but neither is a significant concern. First, if the comparable yield is ordinary but adjustments are capital, added pressure would be placed on the determination of the comparable yield: the difference would become one of character, as well as timing. Indeed, this may have been one reason the Treasury Department chose to make adjustments ordinary under the contingent debt rules. Yet, because the comparable yield is verifiable abusive, planning should be constrained; as a backstop, the Treasury Department could impose a presumption that the comparable yield cannot be below a minimum rate such as the applicable federal rate.

Second, because the rule no longer tracks the contingent debt rules, taxpayers and auditors would have to learn more than one variation of these regimes. An all-ordinary regime would introduce other discontinuities (*e.g.*, with nonprepaid forwards) that taxpayers and auditors would have to master. In any event, conforming changes to the contingent debt regime would eliminate this concern.

4. Inconsistency and Planning

An important advantage of treating adjustments as capital in character is consistency with nonprepaid forwards, options not subject to our proposal, and the underlying property. Thus, our proposal reduces the incentive to replace prepaid forwards and deep-in-the-money options with these other instruments. Although a tax difference will remain because instruments subject to our proposal carry an imputed yield that the others do not, the stakes would be diminished considerably.

Our proposed character rule could create two planning opportunities, though. First, as noted above, taxpayers might have greater incentive to manipulate the comparable yield. Second, our proposal is not consistent with the character rules for contingent debt, but a conforming change would avert this inconsistency. Admittedly, changes in this regime would entail potentially complex considerations. We would be pleased to comment further on these issues if the Treasury Department is interested in this suggestion.[41]

5. Authority

Treatment of adjustments as capital in character generally is consistent with current law, for instance, Sections 1234 and 1234A.

C. Treatment of Physical settlement

1. Description

Under current law, cash settlement of an option or forward produces a realization event. Parties report gain or loss based on differences between amounts they have paid and amounts they have received. But, physical settlement on option exercise — that is, delivery of the underlying

[41] For example, if the character of adjustments on contingent debt is capital, the result diverges from the ordinary character of periodic interest payments on so-called variable rate debt instruments governed by Treas. Reg. § 1.1275-5.

property — generally is not a realization event to the buyer under current law. The same conclusion is likely also for physical settlement of a prepaid forward, although as noted above, there is no clear authority on point. Thus, the party receiving the property (*i.e.*, the holder of a call option, the grantor of a put option, or the buyer of a prepaid forward contract) generally is treated as making a purchase on the option exercise or prepaid forward settlement date and recognizes no taxable gain or loss until this purchased property is sold.[42] The party delivering the property (*i.e.*, a holder of a put option, a grantor of a call option, or a seller on a prepaid forward contract) is treated as selling the property.[43]

We would retain this current law treatment. Specifically, we would not treat physical settlement as an occasion to rectify disparities between the assumed and actual yield. We thus recommend departing from the contingent debt rules that treat physical settlement as triggering adjustments.

To illustrate the difference between these approaches, assume a taxpayer pays $30 for an in-the-money call option to purchase stock in three years for $40, when the current market price is $60. Assume also that the option grantor's comparable yield is 10%. The holder would accrue (and the

---

[42] A possible exception is an option or forward that is "net settled," with the underlying property delivered in satisfaction of net settlement. For instance, assume a holder has an option to buy 100 shares of stock for $100, and the value of the 100 shares increases to $300. If this option is "net settled," the grantor of the call option should pay the holder $200. What if, instead of delivering $200 in cash, the grantor delivers $200 worth of stock (*i.e.*, 67 shares)? Arguably, receipt of this $200 worth of stock would be a taxable event to the holder, because the traditional "merger" authorities may not apply outside the context of a traditional "exercise."

[43] For a description of these rules, see Steinberg, *supra* note 4, at 221-26.

grantor would deduct) 10% each year: $3.00 in the first year, adjusting basis to $33; $3.30 in the second, adjusting basis to $36.30; $3.63 in the third, adjusting basis to $39.93. If the option is physically settled when the underlying property is worth $90, the holder's net economic profit on the overall transaction is $20 (*i.e.*, $50 of intrinsic value on the option minus the $30 premium paid). This profit exceeds the assumed yield by $10.07.

Under our proposal, the taxpayer would have a basis of $79.93 in the stock acquired through physical settlement (*i.e.*, the $40 exercise price plus the $30 premium on the option plus the $9.93 assumed yield). Thus, the taxpayer would have $10.07 of built-in gain that would not be recognized until the stock is sold.

By contrast, if physical settlement were to trigger an adjustment, as under the contingent debt rules, the parties would be treated as engaging in two transactions: (1) cash settlement of the option, followed by (2) transfer of the underlying property for its fair market value.[44] Thus, the option holder would have $10.07 of gain and a $90 basis in the property.

2. Accuracy

Our proposal is somewhat less exact than the contingent debt rules because the assumed yield would not always reflect the forward or option's actual economic performance. Adjustments would enhance the system's accuracy by basing tax liability on actual market conditions, as a mark-to-market system would. The earlier the adjustment, the closer the resemblance to a mark-to-market system. Deferral would be limited to the instrument term.

[44] The Clinton Administration proposed a similar mechanic for purposes of applying the straddle rules and we endorsed that proposal with certain changes. New York State Bar Association Tax Section, *Comments on Proposed Straddle Legislation*, *reprinted in* 87 Tax Notes 823 (May 8, 2000).

3. Complexity

An advantage of our proposal is administrability. Taxpayers would not have to analyze a single transaction, physical settlement, as two hypothetical transactions (*i.e.*, cash settlement followed by transfer of the property). Nor would there be need to value the property upon physical settlement, as would be required for an adjustment. Valuations would be especially difficult if the property is not publicly traded and there is a significant risk of self-serving valuations.[45]

4. Inconsistency and Planning

An important advantage of our proposal regarding the treatment of physical settlement is consistency with nonprepaid forwards, as well as with options not subject to the proposal. Of course, as with any incremental reform for derivatives, inconsistencies would remain. First, the proposal is not consistent with the contingent debt regulations, although a conforming change to the contingent debt regime would resolve this problem. Second, like current law for nonprepaid forwards and options not subject to our proposal, physical and cash settlement would be treated differently. For instance, the holder of a call option is likely to prefer cash settlement if the option has yielded a loss, and physical settlement (and thus deferral) if the option has yielded a gain. Were physical settlement to trigger an adjustment, there would be no deferral of gain or loss in cash or physical settlement.[46]

---

[45] We note that if, contrary to our suggestion, physical settlement were treated as requiring an adjustment, the concern regarding self-serving valuations could be mitigated, to a degree, by requiring both parties to use the same valuation. But symmetry has significantly less effect if the parties are subject to different timing or taxation rules (*e.g.*, if one party is a dealer that marks to market, a foreign person, a loss corporation or a tax-exempt entity).

[46] While our proposal would thus allow disparity in timing, there would be no disparity in character. As noted above, we propose that all adjustments be capital. Thus, gain or loss upon cash settlement would have the same capital character as gain or loss from later selling underlying property received upon physical settlement. If our recommendation as to character is not accepted – that is, if adjustments are ordinary – there is a stronger case for treating physical settlement as a realization event. For example, assume a buyer of a prepaid forward has paid $100, and has accrued interest income at the rate of 10% compounded annually for two years. Her basis in the forward is now $121. Treating adjustments as ordinary while treating physical settlement as not a realization event for the buyer would allow undesirable electivity. Under that regime, if the underlying property were worth $100, the taxpayer could elect accelerated *ordinary* losses of $21 by cash settling. But, if the property were worth $221, the taxpayer could elect deferred *capital gain* by physically settling the forward and subsequently selling the underlying property. To prevent

5. Authority

Under current law, physical settlement generally does not trigger a realization, as discussed above.

III. ALTERNATIVE APPROACHES

This Part considers three alternatives to our proposal: a realization-based approach, such as current law; an imputed-yield approach that more closely tracks the contingent debt regime; and a mark-to-market regime.

A. Traditional Accounting

1. Description

Under this regime, tax consequences generally are deferred until a realization event. The key difference from our proposal is that interest is not imputed.[47]

2. Accuracy

Unlike our proposal, the traditional approach fails to account currently for the time value of a prepayment. Like our proposal, this approach does not account for risk-based returns on an annual

---

undesirable electivity, if adjustments are ordinary (contrary to our proposal), physical settlement should be a realization event for the purchaser.

[47] This rule generally is current law, with five exceptions particularly relevant to financial instruments. First, instead of the traditional rule, mark-to-market accounting applies to certain exchange-traded options (*e.g.*, based on certain commodities and indices). *See* Section 1256. Second, mark-to-market accounting generally applies to positions of securities dealers and designated electing commodities and securities traders. *See* Section 475. Third, the contingent debt rules would apply if a prepaid forward qualifies as debt for tax purposes – for instance, because the prepaid forward is structured to provide principal protection. Fourth, if the prepaid forward contract is bifurcated into a nonprepaid forward contract and an interest-bearing bond or deposit – a characterization commonly proposed for mandatorily exchangeable securities, as noted above – interest would accrue prior to realization. Finally, in some cases the seller in a prepaid forward may be treated as transferring tax ownership. *See* Edward Kleinbard, *Risky and Riskless Positions in Securities*, Taxes 783, 793 (Dec. 1993); David S. Miller, *Taxpayers' Ability to Avoid Tax Ownership: Current Law and Future Prospects*, 51 Tax Lawyer 279. Alternatively, the forward may trigger a constructive sale in which taxpayers are treated as selling and repurchasing the property for fair market value. *See* Section 1259.

basis (and, in the case of a purchaser, also does not measure risk-based returns when the transaction closes with physical settlement).

3. Complexity

The principal advantage of the traditional rule over our proposal is its simplicity and administrability. Complex rules and calculations, such as computation of an imputed return, adjustment of basis, and the like are avoided. Nor do taxpayers face liquidity constraints from phantom income.

While our proposal entails added complexity, similar costs already arise for original issue discount bonds and contingent debt, as well as for nonprepaid forwards paired with discount bonds (in which the phantom income may exceed the cash coupon paid). Moreover, our proposal would retain realization accounting for more conventional instruments (*e.g.*, exchange-traded options on single stocks that are not deep-in-the-money or long-dated). The more tailored and less conventional instruments subject to our proposal are likely to be held by wealthy taxpayers,[48] who generally have access to the necessary advice and liquidity.

4. Inconsistency and Planning Opportunities

An advantage of applying the traditional approach to all options and forwards is that the same rule generally is used to tax the underlying property (*e.g.*, stock). As a result, an investor generally does not have a tax-based preference for choosing between forwards and options, on one hand, and the underlying property on the other. Assuming the traditional rule will continue to apply to the

[48] Under the Commodities Futures Modernization Act, certain over-the-counter derivatives transactions are clearly enforceable, without regard to the Commodities Exchange Act or state gambling laws, only by "eligible swap participants" that hold minimum levels of assets.

underlying — an assumption that seems politically realistic in the near term — relatively strong arguments persist for retaining the traditional rule for options and prepaid forwards.

On the other hand, current law sanctions several inconsistencies our proposal would remedy. Under current law prepaid forwards and loans paired with nonprepaid forwards (or, arguably, with bullet swaps) are treated inconsistently. Our proposal eliminates this inconsistency. Likewise, current law tolerates stark inconsistencies between all these instruments and the underlying, on one hand, and contingent debt on the other. As a result, taxable investors can take long positions subject to traditional accounting, such as prepaid forwards, while taking short positions that generate imputed deductions and ordinary adjustments, such as contingent debt.[49] Our proposal would reduce the inconsistency between contingent debt and designated options and prepaid forwards, and would eliminate this inconsistency entirely if conforming changes were made to the contingent debt rules.

5. Authority

In referring to the traditional approach, we refer to what current law is (or is generally thought to be). There is no doubt regarding the Treasury Department's authority to follow this approach.

B. Strict Extension of Contingent Debt Regulations

---

[49] *See* David Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. Cal. L. Rev. 1339 (2000). Thus, if tax-sensitive investors desire meaningful principal protection but wish to avoid the contingent debt regulations, the transaction can be structured as two legally-separable securities: a fixed-rate discount bond and an option. There is less original issue discount than under the contingent debt rules, and the risk-based return is capital. If tax-sensitive holders do *not* require meaningful principal protection, they can purchase a mandatorily exchangeable security that is marketed, insofar as tax characterization is concerned, as a nonprepaid forward contract paired with a bond or deposit. *See* Edward Kleinbard & Erika Nijenhuis, *Everything I Know About New Financial Products I Learned From DECS*, *reprinted in* 12 P.L.I. Tax Strategies 1171 (1999). If holders are tax-indifferent, the issuer may *want* the contingent debt regulations to apply. To ensure this result, investors can be guaranteed return of principal (a so-called "optionally exchangeable" security). If the maturity is sufficiently long (*e.g.*, 30 years), this principal protection has a low present value. For descriptions of these transactions, see the Appendix. As noted above, tax arbitrage is less likely now that the government has proposeed regulations under Section 263(g).

1. Description

Another alternative to our proposal would be to tax deep-in-the-money options and prepaid forwards under a rule similar to the contingent debt regime. Ordinary interest would be imputed, as under our proposal. Adjustments would be ordinary and physical settlement would trigger adjustments.

2. Accuracy

In imputing interest, this regime shares the accuracy related benefits of our proposal. Another accuracy-related advantage is added by treating physical settlement as a realization event.

3. Complexity

This approach is more complex than our proposal in two respects. First, if physical settlement is a realization event, the underlying property must be valued, a frequently difficult and uncertain process if the property is not publicly traded.[50] Second, if adjustments are ordinary, taxpayers could face a character mismatch in hedging (*i.e.*, if the hedging regulations of Treas. Reg. § 1.1221-2 do not apply). Assume a taxpayer buys a prepaid forward and hedges as a seller of a nonprepaid forward with corresponding terms (the "hedge"). The prepaid forward is assumed not to qualify under the hedging regulations as ordinary property (*i.e.*, because the property could generate capital loss).[51] The net effect of these two positions is the taxpayer has lent money at a fixed rate.[52] Under our

---

[50] The costs of this complexity are mitigated by the fact that these rules also are used for contingent debt. Thus, taxpayers and I.R.S. auditors can benefit from "economies of scale" in learning these various regimes. Yet, the same advantage would be attained if conforming changes are made to the contingent debt regime.

[51] *See* Treas. Reg. § 1.1221-2(b) (defining hedging transactions).

[52] Assume the taxpayer pays $100 for the prepaid forward contract, and in two years will receive a quantity of stock that will vary with the stock price. At the same time, the taxpayer contracts to *deliver* this varying quantity of stock to a different person in two years in exchange for $121, payable in two years. Because the receipt and delivery of stock cancel out, the net effect of these two transactions is a loan of $100 today in exchange for the right to receive $121 in

proposal, this economic reality would be reflected in the tax treatment. Prior to maturity, the taxpayer would have imputed interest income on the prepaid forward. If both instruments are cash settled at maturity, tax consequences on the prepaid forward and hedge would offset each other — because, under our proposal, gains and losses would be capital on each instrument.[53] If instead adjustments on the prepaid forward were ordinary, as under the contingent debt approach, there would be a mismatch: consequences on the prepaid forward would be ordinary, but consequences on the hedge would be capital (assuming the hedging regulations would not apply).[54] If our character recommendation is not accepted, modifications in the hedging regulations or some form of integration should be considered.

---

two years.

[53] Assuming the comparable yield of the prepaid forward counterparty is 10%, the taxpayer would include $10 in the first year and $11 in the second. If the stock price rose more than 10% (*e.g.*, to $131), the taxpayer would have capital gain on the adjusted difference (*i.e.*, $10), and a perfectly matching capital loss on the hedge (*i.e.*, $10).

[54] Note that the integration rule of Treas. Reg. § 1.1275-6 is not available under current law if the prepaid forward does not qualify as debt. Moreover, under the contingent debt approach, this character mismatch would also arise if the prepaid forward were physically settled because, unlike under our proposal, physical settlement would be a realization event. On the facts assumed above, for instance, physical settlement of the prepaid forward would trigger $10 of ordinary gain (*i.e.*, because the property has appreciated to $131). But, physical settlement of the nonprepaid forward would yield a capital loss of $10 (*i.e.*, because the property's basis would be $131, but only $121 would be realized). Under our proposal, the mismatch would not arise. On the prepaid forward, the taxpayer would take the property with a $121 basis (*i.e.*, because physical settlement would not trigger an adjustment). On the nonprepaid forward, the taxpayer would deliver property with a $121 basis for $121 (*i.e.*, the forward price on the nonprepaid forward), leaving no gain or loss.

4. Inconsistency and Planning Opportunities

Unlike our proposal, the contingent debt regime would introduce disparities – both in character and in the timing consequences of physical- settlement – between nonprepaid and prepaid forwards, and between regular options and deep-in-the money and long-dated ones. The main advantage over our proposal is greater consistency with the contingent debt rules, but this advantage would also be attained if conforming changes are made to the contingent debt rules.

5. Authority

The regulatory authority for the contingent debt rules in Section 1275(d) applies only to debt instruments, not to prepaid forwards and options. Sections 7872 and 446 may permit resolution of timing issues, although the case is not free of doubt, as discussed above. On questions of character, these authorities do not apply. For instance, if the Treasury Department determines to treat adjustments at maturity or upon realization as ordinary, instead of capital, that treatment may conflict with Sections 1234 and 1234A (although there is some dispute as to whether Section 1234A applies to scheduled terminations).[55] Given this tension, legislation would be preferable if a regime based on the contingent debt regulations were to be implemented.

C. Mark-to-Market Accounting

1. Description

Another alternative would require mark-to-market accounting for designated prepaid forwards and options, requiring parties to recognize gains or losses based on changes in market values, without regard to whether a realization event has occurred. Because taxpayers would no

[55] New York State Bar Association Tax Section, *Report on Notional Principal Contract Character and Timing Issues, reprinted in* 98 TNT 104-78 (June 1, 1998).

longer have a timing option, there would be less need for loss limitation rules. Thus, character might be ordinary (or capital, but with the capital loss limitations deemed inapplicable or modified).[56]

2. Accuracy

Unlike our proposal, mark-to-market accounting offers an accurate annual tally of each position subject to this regime. By periodically measuring the risk-based return, this method revokes the taxpayer's timing option, something our proposal does not achieve. On the other hand, mark-to-market accounting can yield fundamentally *inaccurate* results when it applies to only part of a portfolio. For instance, if only one of two offsetting positions is subject to mark-to-market accounting, taxable income will diverge from economic income as the offsetting positions fluctuate in value.

3. Complexity

Unlike our proposal, mark-to-market would require periodic valuations prior to realization. If the derivative itself is publicly traded, valuation is relatively straightforward.[57] But if neither the derivative nor the underlying property is publicly traded, valuation can be difficult. If the underlying property is publicly traded but the derivative itself is not, valuation remains a concern because factors other than the underlying property's value contribute to the derivative's value (*e.g.*, duration and volatility). The I.R.S. may be hard pressed to detect self-serving valuations. On the other hand,

---

[56] For instance, mark-to-market losses could constitute a second basket of capital losses that are applied first to offset capital gains (*e.g.*, ahead of other capital losses), but then might be used to offset ordinary income. The offset might be less than dollar-for-dollar to correct for the rate differential. In addition, a mixed-straddle-type regime would still be needed to prevent tax arbitrage involving offsetting positions, of which only one was subject to mark-to-market accounting. This type of complexity, though, is itself an argument against mark-to-market accounting.

[57] Given this reality, one approach that poses relatively modest administrative costs is to expand Section 1256 to reach other publicly-traded derivatives. This rationale for mark-to-market, though, extends beyond prepaid forwards and options to *any* publicly traded derivative -- and, indeed, to the underlying property as well. Congress recently declined to take this course with publicly-traded securities futures. See Section 1234B.

securities dealers already are required to mark to market securities other than those held for investment. It might be possible to require securities dealers to share valuations with counterparties. If mark-to-market accounting is extended to include any position taken with a securities dealer, the hard work of valuation might already have been done. It should be noted, though, this rationale for mark-to-market extends beyond prepaid forwards and options (*e.g.*, to swaps, nonprepaid forwards, and the like).

4. Inconsistency and Planning

Mark-to-market accounting would reduce taxpayer incentive to engage in strategic trading (*e.g.*, selling to trigger loss and holding to defer gain). Mark-to-market accounting would also be more consistent with Section 1256's treatment of certain publicly traded derivatives,[58] but our proposal is more consistent with nonprepaid forwards and swaps paired with loans, as well as with contingent debt (especially if conforming changes are made). Finally, unlike our approach, the mark-to-market alternative would ensure that securities dealers and their counterparties were governed by the same timing rule, because dealers already mark their positions to market under Section 475. By leaving the dealer and its counterparty on different tax timing regimes, our proposal could invite tax planning.[59] If the counterparty also were required to mark to market, both parties to the transaction would be taxed under the same rule and these planning opportunities would no longer be available.[60]

---

[58] Some members of the Executive Committee noted that they do not believe there is much tax-motivated switching from publicly-traded to over-the-counter options because these option classes currently differ in significant nontax ways. For instance, for public investors, Section 1256 contracts do not include options on single stocks. (So-called dealer equity options, which are Section 1256 contracts, are marked-to-market only by the dealer.)

[59] As noted above, securities dealers are able to function as accommodation parties because they usually incur no added tax cost in facilitating clients' choices as to structure and timing.

[60] *See* Schizer, *supra* note 50, at 1374.

Although there may be reason to expand mark-to-market accounting, it is not clear why prepaid forwards and options are the proper next step, rather than one or more other classes of derivatives. Indeed, this route tends to be more appealing if the class of covered instruments is broadened. Otherwise, there would always be a concern, commonly expressed elsewhere, that taxpayers would respond by avoiding instruments subject to mark-to-market. The broader the set of instruments subject to mark-to-market, the harder it will be for taxpayers to opt in and out of this sector. In our view, prepaid forwards and deep-in-the-money options are a fairly small set of instruments, and so the risk of electivity is real.

5. Authority

The regulatory authority to implement mark-to-market accounting for prepaid forwards and options is limited at best. As authority to impute interest, Section 7872 is not applicable here. A statute has been used to implement mark-to-market accounting in other contexts,[61] and we believe that course would be required here as well.

D. Appendix: Applications to Common Transactions

This appendix considers four types of transactions: a call option; a prepaid forward contract; an equity-linked security with meaningful principal protection, of which two types are considered – a contingent note and an investment unit; and an equity-linked security with *no* meaningful principal protection, of which three types are considered – a long-dated optionally exchangeable security, a variable-delivery prepaid forward, and a forward-deposit unit. For each transaction, we contrast current law with our proposal to illustrate our proposal and to show its effect on inconsistencies

[61] *See, e.g.*, Sections 1256 and 475.

under current law. In all example (unless otherwise stated), parties to the transaction are not subject to special rules and thus, for example, would treat stock as a capital asset.

IV. CALL OPTION

Holder (H) pays Writer (W) $35 for a call option entitling H to buy 1 share of stock for its current price of $100 at any time during the next ten years.

A. Current Law

1. Option-Holder

H has a $35 basis in the option and no taxable income or loss until the option is sold, exercised or lapses.[62] If H sells the option, H will recognize capital gain or loss based on the difference between the amount realized and her $35 basis.[63] If the option is physically settled, exercise is not a realization event. H is simply treated as purchasing stock, and H's basis is the sum of the exercise price and the option premium (*i.e.*, $100 plus $35).[64] If the option is cash settled, H recognizes capital gain or loss based on the difference between the cash received and the premium paid.[65] If the option lapses, H has a $35 capital loss equal to the premium paid.[66]

---

62 *See* Rev. Rul. 78-182, 1978-1 C.B. 265.

63 *See* Section 1234(a)(1) (character is same as underlying property would have in H's hands; here stock is assumed to be capital asset).

64 *See* Rev. Rul. 78-182.

65 *See* Section 1234(c).

66 *See* Rev. Rul. 78-182.

2. Option-Writer

W has no income upon receiving the option premium.[67] If H exercises the option, W's tax consequences on the option merge with sale of the underlying. W has capital gain or loss based on the difference between the amount realized on the sale — $135, the exercise price of the option plus the $35 option premium — and W's basis in the underlying stock.[68] If the option is cash settled, W has capital gain or loss based on the difference between the premium received and the amount W must pay to settle the option.[69] If the option lapses, W has short-term capital gain equal to the $35 premium.[70]

B. Our Proposal

1. Holder

Assuming W's usual borrowing cost is 8%, H will have $2.80 of ordinary income in the first year (*i.e.*, .08 * 35), and H's basis in the option will step up to $37.80. In the second year, H will have $3.02 of income (*i.e.*, .08 * 37.80) and a basis increase to $40.82. After 8% accruals for ten years, H's basis will be $75.56.[71]

Assume the underlying property is worth $225. In cash settling the option, H would receive $125 in cash (*i.e.*, $225 minus the $100 exercise price) and would have capital gain of $49.44 (*i.e.*,

---

67 *See* Rev. Rul. 78-182.

68 *See* Rev. Rul. 78-182.

69 *See* Section 1234(c).

70 *See* Rev. Rul. 78-182.

71 The accruals are $3.27 in the third year, $3.58 in the fourth, $3.81 in the fifth, $4.11 in the sixth, $4.44 in the seventh, $4.80 in the eighth, $5.12 in the ninth, and $5.60 in the tenth.

the difference between the $125 cash received and her $75.56 basis). In physically settling the option, H would have no gain and would have a basis of $175.56 in the underlying property.

Alternatively, assume the underlying property is worth $50, and the option lapses. H would have a capital loss of $75.56. (As noted above, there is a character mismatch between the pre-realization accruals of $40.56 and the offsetting capital loss upon lapse; while this mismatch is not troubling, a possible alternative would be to treat the deduction as ordinary to the extent of prior ordinary income inclusions, as under the contingent debt regulations.)

2. Writer

W will have annual ordinary interest expense equal to H's annual inclusions (*e.g.*, $2.80 in the first year, $3.02 in the second, etc.) Deductibility of this interest is subject to otherwise applicable limitations such as the straddle rules and investment interest limitations.

When the option matures, assume the underlying property is worth $225. In cash settling the option, W would pay $125 in cash, which is $90 more than the $35 premium received. Of this $90 economic loss, W already has deducted $40.56, leaving a capital loss upon cash settlement of $49.44 (subject to the straddle rules). By analogy to the contingent debt rules, the "projected payment" is $75.56 (*i.e.*, the premium plus the $40.56 accrual), and the actual payment of $125 exceeded this projection by $49.44.

Alternatively, if the option is physically settled, W's tax consequences would merge with the sale of the underlying property. (Unlike the contingent debt rules, there is no separate realization event on the option exercise under our proposal.) Thus, W would be treated as selling the property for $175.56, which is the sum of the $100 exercise price, the $35 premium, and the $40.56 already

accrued. Thus, if W purchased the underlying stock for $225, W would have a capital loss of $49.44, which is the same as the loss generated from cash settlement.

Finally, if the option lapses, W would have a short-term capital gain of $75.56, which is the sum of the $35 premium and the $40.56 already accrued. Note the potential character mismatch here as well: ordinary interest expense and offsetting capital gain. If the interest expense is capitalized under Section 263(g), as would occur if W holds the underlying stock as a hedge, the character mismatch would disappear.

V. PREPAID FORWARD

To illustrate prepaid forwards, assume Buyer (B) pays Seller (S) $100 today for delivery in three years of a fixed amount of stock (*e.g.*, one share) currently worth $100 that is not expected to pay dividends.

A. Current Law

While current law for prepaid forwards is less well established than the law for options, the following is thought to be the treatment.[72]

1. Buyer

Upon making the $100 payment, B takes a $100 basis in the forward contract. If B sells the contract, B will recognize gain or loss based on the difference between the amount realized and his $100 basis. If the forward is physically settled, B would have no realization event and would have a $100 basis in the stock. If the forward is cash settled, B would recognize gain or loss based on the

[72] For further discussion, *see* Steinberg, supra note 4, at 225; Andrea S. Kramer, Financial Products: Taxation, Regulation, and Design § 42.1(b) (Rev. ed. 1991) (" Because no special rules apply to govern the tax consequences of gain or loss inherent in or realized by a party that enters into a forward contract, the tax consequences are governed by the general rules applicable to gain or loss realized on the sale or disposition of an asset.")

difference between the cash payment received and his $100 basis. This gain or loss is, in all likelihood, capital in character.[73]

2. Seller

Assuming S does not hold the stock upon entering into the forward contract (or holds stock that is not appreciated), S would have no gain or loss upon receiving the $100 payment. If S later buys the stock and physically delivers it, S's gain or loss is based on the difference between $100 and the basis in the stock S delivers. If S cash settles the contract, S's gain or loss is based on the difference between $100 and the payment made to settle the contract.[74] Alternatively, if S holds appreciated stock upon entering into the forward contract, and the contract provides for delivery of a substantially fixed amount of stock at a substantially fixed price, S would have a constructive sale of the appreciated stock.[75] S would thus recognize gain as if the stock had been sold for its $100 fair market value, and S's basis in the stock would step up to $100.

B. Our Proposal

1. Buyer

Assuming the seller's comparable yield is 8%, B would accrue $8 of ordinary income in the first year and B's basis in the forward would step up to $108. In the second year, B would accrue

---

[73] Terminations under Section 1234A generally give rise to capital gain. If the cash settlement is part of an unscheduled termination, Section 1234A would apply. If the cash settlement occurs as scheduled at maturity, there is some question whether a "termination" has occurred. *See* New York State Bar Association Tax Section, *Report on Notional Principal Contract Character and Timing Issues*, *reprinted in* 98 TNT 104-78 (June 1, 1998).

[74] If S holds stock at the time of cash settlement, losses could be deferred under the straddle rules. Under proposed regulations under Section 263(g), losses would be capitalized into the retained stock apparently without regard to whether the stock was appreciated.

[75] *See* Section 1259.

$8.64 and increase his basis to $116.64. In the third year, B would accrue $9.33 and his basis would be $125.37.

Assume the forward is cash settled and the underlying property is worth $225. B would recognize $99.63 of capital gain. Alternatively, if the forward is physically settled, B would not have a realization event and would take the property with a basis of $125.37.

2. Seller

S would have interest expense equal to B's annual inclusions, *i.e.*, $8 in the first year, $8.64 in the second, and $9.33 in the third. Deductibility of this interest would be subject to otherwise applicable limitations, such as the straddle rules.

Assume that entry into the forward contract has not triggered a constructive sale, and that the forward is cash settled when the underlying property is worth $225. S would have an economic loss of $125, because S received a prepayment of only $100. Yet S has already deducted $25.37, and so the additional capital loss is $99.63 (subject to the straddle rules). Alternatively, if the forward is physically settled, S's tax consequences merge with the sale of the underlying property. (Unlike the contingent debt rules, there is no separate realization event on the forward under our proposal.) Thus, S would be treated as selling the underlying property for $125.37, which is the sum of the $100 that S received and the interest expense that S has already deducted. Thus, if S purchased the property at $225, S would have a $99.63 capital loss (subject to the straddle rules), which is the same result as under cash settlement.

VI. EQUITY-LINKED SECURITY WITH PRINCIPAL PROTECTION

Two structures can be used to achieve this economic result: a contingent bond or an investment unit composed of a fixed-rate bond and an option. Under current law, there is

inconsistency of both timing and character. Under our proposal, timing and character are *more* consistent but not fully consistent (unless conforming changes are made to the contingent debt rules). After describing the treatment of a contingent bond, this Part will explore the treatment of an investment unit under both current law and our proposal.

A. Contingent Bond

Issuer issues a zero-coupon bond for $11,000. After five years, issuer will pay holders $11,000 plus the amount, if any, by which the Dow Jones Industrial Average (the "Dow") exceeds 11,000.[76] The issuer's usual borrowing cost is 8%. Under the contingent debt regulations, the tax treatment is as follows (assuming the payoff at maturity is exactly as expected):

Year	***Holder Income / Issuer Interest Expense***
1	880
2	951
3	1,026
4	1,109
5	1,197
Total	**5,163**

Given the accelerated timing and the ordinary character of the return, this structure will not appeal to taxable holders. While these transactions are common, anecdotal evidence suggests they frequently are marketed to tax-indifferent holders, including pension funds, insurance companies using segregated accounts, and foreign persons. Theoretically, taxable issuers would benefit from the accelerated timing and ordinary character (as evidenced in the example below of the long-term optionally exchangeable debt security). Yet for shorter transactions such as this one, anecdotal

[76] This example assumes the Dow is less than 11,000 when the bond is issued.

evidence suggests issuers often hedge the instrument and use the integration rule of Treas. Reg. § 1.1275-6. (Indeed, if the issuer hedged and the integration rules did not apply, the entire interest accrual could be capitalized under the straddle rules, depending upon the precise application of Section 263(g)). As a result, the issuer's tax treatment would be like the investment unit described below.

B. Investment Unit

The same transaction can be structured as two securities: first, a fixed rate bond that costs $7,486 and pays $11,000 at maturity (thus accreting at 8% annually); second, a cash-settlement option that costs $3,514 and pays the excess of the Dow above 11,000 in five years. If the holder has a meaningful ability to sell the securities separately – a condition that increases transactions costs, but not prohibitively – the two components generally would be taxed separately.

1. Current Law

The tax treatment diverges from the contingent debt regulations in two respects that appeal to taxable holders. The timing of income to holders is less accelerated and relatively more of the return is capital:

Year	***Investment Unit: Holder Income***	***Contingent Debt Regulations Holder Income***
1	599	880
2	647	951
3	699	1,026
4	754	1,109
5	815	1,197
	1,649 (capital)	
Total	**5,163**	**5,163**

Thus, the investment unit requires $281 less of inclusions for taxable holders in the first year, and a greater disparity thereafter. This difference arises because, under current law, there is no accrual on the option, as there would be under the contingent debt rules if the option were embedded in a single contingent debt instrument.[77]

2. Our Proposal

Under our proposal, there would be accrual on the option. The option's initial value is $3,514 and so an 8% accrual yields $281 in the first year and a year-end basis of $3,795. Total annual accruals are identical to those under the contingent debt rules:

	Investment Unit: Our Proposal			***Contingent Debt***
Year	***Bond***	***Option***	***Total***	***Regulations***
1	599	281	880	880
2	647	304	951	951
3	699	326	1,026	1,026
4	754	355	1,109	1,109
5	815	382	1,197	1,197
Total			**5,163**	**5,163**

Differences will continue to arise if the assumed and actual yields diverge, as they generally will. For instance, under our proposal, unlike under the contingent debt rules, adjustments are capital in character. Assume the Dow is at 21,163, which is 5,000 more than the 16,163 that is projected.[78]

---

[77] In the example, under the investment unit approach, the 8% assumed yield applies only to the debt, whose value begins at $7,486, thereby generating $599. The assumed yield does not apply to the option, whose value is $3,514. If it did, the additional yield (.08* 3514, or $281) would bring the total yield to $880 (*i.e.*, 599 + 281), which is the result provided by the contingent debt regulations. In other words, under the contingent debt regulations the 8% return applies to the full $11,000, and not just the $7,486 attributed to the fixed rate bond.

[78] This projected amount is the sum of the 11,000 exercise price and the 5,163 of phantom accruals

The cash payment at maturity would be increased by $5000. This extra amount would be capital in character under our proposal, but ordinary under the contingent debt rules.[79]

VII. EQUITY-LINKED SECURITIES WITH LESS MEANINGFUL PRINCIPAL PROTECTION

The inconsistency and electivity characterizing current law persists also in transactions that offer less meaningful principal protection. This economic result is available through at least three structures: a long-dated security that offers principal protection with a low present value and is subject to the contingent debt rules; variable-delivery prepaid forwards; and nonprepaid forwards paired with fixed-rate bonds or deposits. Under current law, there is inconsistency of both timing and character.[80] Under our proposal, timing and character are *more* consistent but not fully consistent (absent conforming changes to the contingent debt rules).

A. Long-Term Optionally Exchangeable Debt Security

Assume an issuer issues a 30-year bond for $100 that pays $100 at maturity plus a payment based on the value of stock in a third party (the "Stock"). This payment will be 95% of the excess, if any, of the Stock's fair market value at maturity over $100 (the latter being the Stock's value when the bond is issued). The bond also pays a coupon equal to one dollar plus the dividend on stock (which we assume is also one dollar). Because maturity occurs in 30 years, the present value of the

---

[79] A second difference would arise if the contingent bond and the option in the investment unit were physically settled through delivery of stocks constituting the Dow (*i.e.*, contrary to the assumption above that these instruments are physically settled). On the contingent bond, the holder has $5,000 of current ordinary income (*i.e.*, because physical settlement triggers an adjustment). Under our proposal (which resembles current law on this issue), the holder would have no realization event, and would take the stocks with a basis of $16,163, leaving $5,000 of built-in capital gain to be taxed when the stocks are sold. (Note that under current law the basis would be only the $11,000 exercise price.)

[80] This is an elaboration of a point made in Part II.A.4. For further discussion of these transactions and the inconsistent tax treatment, see David M. Schizer, *Debt Exchangeable for Common Stock: Electivity and the Tax Treatment of Issuers and Holders*, Derivatives Report, March 2000, at 10.

bond's principal protection is quite small. Much of the bond's expected value resides in the contingent payment at maturity. In effect, the bond's return should track the Stock's return fairly closely.[81]

Nevertheless, the presence of principal protection, as a matter of form, is likely to render this security debt for tax purposes, and thus subject to the contingent debt regulations. The issuer's comparable yield is assumed to be 8%. As a result, the parties accrue $8 in the first year. Basis and adjusted issue price increase to $108, but then are reduced by the $2 periodic payment to $106, yielding an accrual in the second year of $8.48 (*i.e.*, .08 * 106). After thirty years, the accrual in the final year is $58, increasing the holder's basis to $779.

This result can be favorable for the issuer. For thirty years, the issuer's deduction, which is based on its usual borrowing cost, will exceed its cash outlay. If the issuer is hedging by holding the Stock, the issuer will have no offsetting phantom inclusions on the stock, and thus enjoys a form of tax arbitrage, unless the straddle rules require capitalization of some of the deduction, as would be required under Proposed Treas. Reg. § 1.263(g). Although favorable to the issuer (if not for the capitalization of interest expense), long-term optionally exchangeable debt is unfavorable to taxable holders. They would have phantom income inclusions and the entire return would be ordinary, in contrast to the deferral and capital gain from holding the Stock. The likely result, confirmed by anecdotal evidence, is that long-term optionally exchangeable debt securities usually are issued by tax-sensitive issuers to tax-exempt holders.[82]

---

[81] Given this tracking, a tax issue raised by long-term optionally exchangeable debt securities is whether they trigger a constructive sale if the issuer owns appreciated Stock. This issue is beyond the scope of this Report.

[82] *See* Paul M. Sherer, *Eyes on the Prizes: Firm Hopes to Ease Capital-Gains Hit With Hybrid Security*, Wall St. J., Nov. 18, 1999, at C24 (noting difficulty of selling PHONES to taxable holders).

B. Prepaid Forwards and Nonprepaid Forwards Paired With Deposits

Two other structures track the value of the underlying stock to a considerable degree, while generating tax treatments under current law that are inconsistent with each other and with contingent debt.

First, the issuer can enter into a prepaid forward contract to sell third-party stock. In return for an up-front payment, the issuer promises to deliver, in three years, an amount of stock that varies with the stock price (which is assumed currently to be $100). The effect is that the holder bears the full risk of loss in the stock, while enjoying most, but not all, of the opportunity for gain (*e.g.*, no gain between $100 and $120, and 5/6 of gain above $120).[83] To compensate the holder for forgoing a portion of the opportunity for gain (and also for forgoing the dividend), the security is issued at a discount. Instead of paying the full price of the stock ($100), the investor might pay only $84.50.[84]

Second, the transaction can be structured as a "Forward-Deposit." The holder puts down a deposit of $100 that offers an 8% yield, of which $6 is paid in cash and the balance is original issue discount. After three years, the deposit accretes to $106.50. In addition, the parties enter into a

---

[83] In a typical case, if a share of Stock is worth less than $100 at maturity, a full share is delivered. If the stock is worth between $100 and $120, the issuer delivers a fraction of a share that is *worth* $100. (For instance, if the stock price is $110, the issuer delivers 100/110 of a share). If the stock price is more than $120, the issuer delivers 5/6 of a share.

[84] A discount of $15.50 represents the present value of three annual payments of $6 each (discounted at 8%). If the holder would like to receive a periodic payment, instead of buying the security at a discount, the issuer could charge $100 while using the extra $15.50 to buy Treasury Department strips that fund a coupon. This is common in so-called "Trust" structures. The end result offers cash flows similar to the forward / deposit structure described below, but the tax treatment is different. For a description, *see* Schizer, *supra* note 81.

three-year nonprepaid forward contract committing the holder to pay $106.50 and committing the issuer to deliver an amount of third-party stock that varies with the stock price (which is currently at $100). As in the above prepaid forward, the holder bears the full risk of loss in the stock, while enjoying most, but not all, of the opportunity for gain (*e.g.*, no gain between $100 and $120, and 5/6 of gain above $120). This characterization is common for publicly-traded securities mandatorily exchangeable into the stock of a third-party.

1. Current Law

a. Prepaid Forward

While the tax treatment of this structure is not wholly clear under current law, this alternative arguably offers the most deferred timing. In addition, relatively more of the return is capital in character.[85]

Under current law, the holder is thought to have no income prior to maturity.[86] At maturity, if the instrument is cash settled, the holder is thought to have capital gain or loss based on the difference between the amount already paid ($84.50) and the amount received. This capital character diverges from the ordinary return under the contingent debt regulations. If the instrument is physically settled, moreover, the holder is thought to have no realization event, and takes the underlying property with a basis of $84.50.

---

[85] The assumption here is that the prepaid forward is not treated as debt for tax purposes, and so the contingent debt rules do not apply. Although there is some uncertainty, debt characterization is unlikely given the absence of principal protection. Debt characterization is particularly unlikely if the security is physically settled and documented as a prepaid forward rather than a note. *See Deputy v. Dupont*, 308 U.S. 533 (1939) (contract to deliver securities is not indebtedness).

[86] Alternatively, if the holder is receiving a coupon funded by Treasury Department strips, as in the "Trust" structure, a portion of the payment is regarded as interest and a portion is regarded as return of principal.

For issuers, entry into the forward should not trigger a constructive sale as long as the quantity of stock to be delivered is subject to significant variation.[87] Thereafter, loss on the forward from appreciation in the underlying stock (*e.g.*, if the forward is cash settled) is capital instead of ordinary. In addition, the time-value compensation that the issuer pays (*i.e.,* in the form of discount on the prepaid forward) generally is also be regarded as capital instead of ordinary, and the timing of the deduction for this expense is deferred (although the straddle rules could have this effect for any of these structures).

b. Forward-Deposit

The tax treatment here also is not wholly clear under current law. Assuming the deposit and forward are taxed as separate transactions,[88] this structure yields more accelerated timing than the prepaid forward, and approximately the same timing as the contingent debt regulations. However, this structure yields capital gain or loss on the forward, a similarity to the prepaid forward and a difference from contingent debt.[89]

---

[87] *See* Section 1259(d)(1) (defining forward contract as a "contract to deliver a substantially fixed amount of property (including cash) at a substantially fixed price").

[88] The issuer and holders usually agree in the indenture to treat the instrument in this manner for tax purposes. While the case would be strengthened if the mandatorily exchangeable security actually were documented as two securities that could be legally separated, these conditions usually are not satisfied. This step would distinguish authority indicating that a security is generally not treated, for tax purposes, as two separate instruments unless the two pieces can be legally separated. *See, e.g., Chock Full O' Nuts Corp. v. United States*, 453 F. 2d 300 (2d Cir. 1971) (issuer cannot treat convertible debt that has been issued as a single security as if it had been issued as a unit composed of a note and a warrant, even though the two structures are economically similar); *see also National Can Corp. v. United States, 687 F.2d 1107 (7th Cir. 1982). Whereas the Commissioner is free to disregard* form and look to a transaction's substance, the right of a taxpayer to disavow its own form is less clear. *See, e.g., Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967); *Sullivan v . Commissioner*, 618 F.2d 1001 (3d Cir. 1980). Even so, the characterization is a persuasive way to view the economic substance of the transaction. *See* Kleinbard & Nijenhuis, *supra* note 50.

[89] Note also that, as with the prepaid forward, entry into the nonprepaid forward should not trigger a constructive sale for the seller as long as the amount of property to be delivered is subject to significant variation.

Specifically, the holder and issuer each have 8% ordinary accruals on the deposit, as on contingent debt: $8 in the first year, $8.16 in the second, and $8.33 in the third.[90] The key assumption here, which is not universally followed, is that the deposit is treated as yielding original issue discount, so the amount of the accrual exceeds the $6 cash payment. Like the prepaid forward, and unlike the contingent debt rules, cash settlement yields capital gain or loss, and physical settlement is not a realization event to the holder.

2. Our Proposal

Our proposal would change the tax treatment only of the prepaid forward, rendering the treatment more consistent with the Forward-Deposit and closer to, though not perfectly consistent with, contingent debt. Specifically, there would be an 8% ordinary accrual on the prepaid forward, as there is on contingent debt and on the Forward-Deposit.[91] In concluding that consistency thus has been attained, though, we should emphasize our assumption about the Forward-Deposit: Interest on the deposit is assumed to accrete based on the issuer's comparable yield, and not on the cash payment. Thus, if the cash payment is less than the issuer's comparable yield, the deposit is treated as having original issue discount; correspondingly, if the cash payment is *greater* than the comparable yield, the deposit is viewed as issued at a premium. If our proposal is adopted, this treatment of the Forward-Deposit should be required.

---

[90] If the issuer holds appreciated stock, the issuer's deduction would in all likelihood be deferred under Proposed Treas. Reg. § 1.263(g) – 3(b)(1), (3), (c) & (d).

[91] If the prepaid forward is issued at a discount (*e.g.*, $84.50), this 8% comparable yield is applied to a lower base (*i.e.*, $84.50 instead of $100). As a result, the interest inclusion in the first year is $6.76, rather than $8.00. However, this difference reflects a real difference in the economics: a lower purchase price to buy the prepaid forward than the forward / deposit. If the economics are aligned, the tax treatment generally is aligned as well. Thus, assume the prepaid forward is paired with a self-amortizing bond that costs $15.50 and pays $6 per year, while accreting at 8%. The income on this bond in the first year – $1.24 (*i.e.*, .08 * 15.50) – brings the total income to $8, which is the same as in the forward / deposit.

Greater consistency would also be attained when the prepaid forward matures. Physical settlement would not be a realization event to the buyer, and cash settlement would yield capital gain or loss, rather than ordinary income. The same result would hold for the Forward-Deposit, but not contingent debt (unless conforming changes are made, as discussed above).