NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON PREPAID FORWARD CONTRACTS

June 26, 2008

I. Introduction[1]

This report is a response to Notice 2008-2 (the "Notice"), in which Treasury and the Internal Revenue Service (the "IRS") requested comments on a variety of issues relating to the taxation of "prepaid forward contracts." We commend Treasury and the IRS for focusing on these issues, because we believe it is important for the tax system that they address a number of fundamental issues raised by prepaid forward contracts and similar instruments.

In a 2001 report (the "2001 Report"), the Tax Section proposed an accrual regime for prepaid forward contracts and "deep-in-the-money" options (which we'll collectively call "prepaid contracts").[2] Under this regime, the owner of a prepaid contract would accrue interest income (and the issuer would accrue interest expense) at a rate equal to the issuer's "comparable yield." Our 2001 Report expressed a mild preference for treating the entire amount of any additional income or deduction recognized on the occurrence of a realization event as capital.

In the 2001 Report, we said that this regime would enhance the accuracy of the tax system, by treating as interest the "discount" that investors are necessarily credited, economically, for prepaying for a prepaid forward contract. The report proposed a similar regime for "deep-in-the-money" and long-dated options. The 2001 Report was motivated by a sense that the use of prepaid contracts was being driven "by the tax system's mismeasurement of time value."

In the 2001 Report, we proffered two potential sources of regulatory authority to implement our proposal, but noted that it is not clear whether that authority exists. Specifically, we noted that Section 7872 authorizes imputation of interest for certain below-market loans, while acknowledging that it may not be possible to impute interest under Section 7872 to instruments that are not indebtedness for tax purposes. We also observed that Section 446 may provide

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[1] This report was prepared by an *ad hoc* committee of the Tax Section and was principally drafted by Michael Farber, with assistance from Ari Weinstein. Helpful comments were received from Shlomo Boehm, Andy Braiterman, Dickson Brown, James Brown, Adrienne Browning, Oggie Caginalp, Linda Carlisle, Sam Dimon, David Garlock, Marcy Geller, Ed Gonzales, David Hariton, Brenda Hinton, Robert Kantowitz, Stephen Land, David Miller, Steve Mills, David Schizer and Mike Schler.

[2] The question of what is debt and what is a prepaid contract not subject to any imputation or other "current inclusion" regime under current law is beyond the scope of this report. We note only that the Notice fairly clearly indicates that under current law, that line exists, and this report discusses instruments that fall into the latter category. That said, we recognize that some instruments that are in form prepaid contracts could be viewed as indebtedness, for example if they provide for sufficiently high buffers or other features that it is virtually impossible for investors to sustain significant losses by the terms of the contract. We would be happy to consider these issues further if Treasury and the IRS are interested in pursuing them.

authority for the proposed regime, assuming imputation constitutes an accounting method. The 2001 Report acknowledged, however, that Section 446 can be used only to determine the timing of income, not to create items of income that might not otherwise exist.

In the intervening time period, prepaid contracts have become enormously more accessible and complex than they were when we addressed the issue in 2001. Of particular significance, there is an astounding variety of SEC-registered instruments being issued by financial institutions and other entities that defy simple categorization under the tax law. Most of these instruments have a duration of no more than five years, are typically "price return" (*i.e.,* do not credit investors with interim payments or accruals of interest, dividends or other income that would be generated by the underlying assets), and are structured to provide investors with highly customized exposures to one or more asset classes, which they could not otherwise obtain without great expense and/or expertise. These "customized" instruments will often include "buffers,"[3] "leverage,"[4] "knock-out"[5] and/or "autocall"[6] features, and other provisions intended to tailor investors' exposure to specific assets or events.

More recently, the evolution of, and media focus on, "exchange-traded notes" (or "ETNs") have motivated both Congress and the Treasury to focus on the taxation of these instruments. ETNs are essentially long-dated, "total return," cash-settled prepaid forwards with respect to one or more assets or indices, that are traded on an exchange and can be redeemed at the investor's option on short notice under certain circumstances.

In particular, the Notice reflects Treasury's recognition that the law applicable to prepaid forward contracts is not clear, and that prepaid contracts

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[3] A "buffer" is partial protection against a decline in value of the underlier. An instrument with a 10% buffer would provide the investor with no loss of her investment in connection with an up to 10% decline in the value of the underlying asset(s).

[4] A "leveraged" exposure to an underlier would provide the investor with a specified multiple of the return (positive or negative) on the asset. Leverage need not be symmetrical; for example, an instrument could provide for 120% exposure to the increase in value of an asset or index and only 100% exposure to the decrease in value.

[5] A "knock-out" feature is one that is eliminated on the occurrence of a specified event. So an instrument could provide for a 10% buffer that "knocks out" if the underlier declines by more than 30%, which would mean that the investor's partial protection against declines in value of the underlier (see note 3, above) would fall away once the underlier falls by more than 30%.

[6] An "autocall" feature is a provision that the instrument becomes mandatorily redeemable for a specified price on the occurrence of a specified event. For example, an instrument might provide that once the underlier increases in value by more than 20%, the instrument becomes automatically redeemable the following day for the amount that would have been due if that day had been the maturity date.

exist as a class of instruments distinct from debt. The Notice asks in particular whether a regime such as imputation or mark-to-market should be adopted for these instruments, as well as a series of related or ancillary questions.

Contemporaneously with the publication of the Notice, Congressman Neal proposed legislation (the "Neal Bill") that would require investors to accrue income (but would not permit issuers to accrue expense) with respect to "prepaid derivative contracts".[7] More recently, a hearing of the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means heard testimony regarding various issues relating to derivatives, with an emphasis on prepaid contracts in general and ETNs in particular.

The remainder of this report is divided into four Parts. In Part II, we discuss a variety of possible regimes for taxing prepaid contracts (including those specifically identified by the Notice, imputation and mark-to-market, as well as several others), and some of the advantages and disadvantages of each. In Part III, we address the remainder of the specific questions posed by the Notice. In Part IV, we address a variety of issues specific to certain types of prepaid contracts that we think merit further consideration but that are not raised by the Notice. Finally, in Part V, we offer some fairly technical observations regarding aspects of the Neal Bill.

Our conclusions in general are that (i) it is important that Congress and/or Treasury provide some guidance on the basic taxation of prepaid contracts, (ii) any method of taxing prepaid contracts (or any other "category" of instrument) should be broadly conformed with the taxation of other, similar positions or combinations of positions (meaning that in some circumstances, changes to other regimes should also be considered),[8] and (iii) while there is no "correct" method of taxing prepaid contracts, on balance we would support either an imputation regime similar to the one we proposed in our 2001 Report or the one proposed in the Neal Bill or a regime that treats any gain (or, in the issuer's case, loss) recognized with respect to a prepaid contract as ordinary income (loss) to the extent of accrued time value. Generally, we believe that gains on prepaid contracts, after accounting for the time value component, as well as losses in excess of prior inclusions of ordinary income, should be capital, and that the

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[7] The bill would define a "prepaid derivative contract" generally as any prepaid contract (i) with a term of longer than one year and (ii) that is a derivative financial instrument with respect to any security (as defined), commodity (as defined), or financial index. For a more complete definition, including exceptions, see H.R. 4912 (proposing a new Section 1290).

[8] Throughout this report, we note similarities or highlight differences between a particular prepaid contract and one or more other positions or groups of positions, including debt instruments, non-prepaid forward contracts, notional principal contracts, stock, and options. Each of these categories of instrument is subject to materially different taxation regimes under current law, and we are concerned about the complexity, electivity and potential for abuse inherent in a system that permits or requires materially different tax accounting for economically similar positions.

contingent debt regulations should be conformed in this regard. We do not have a consensus view on whether losses should be ordinary or capital to the extent of prior inclusions of ordinary income.

We also note generally that there may be some merit to considering the implementation of a "safe harbor" from any regime chosen for the taxation of prepaid contracts. For example, it might be determined that instruments with a relatively short duration (say, three years or less) or a relatively small amount of "time value" at issue should not be subjected to any special regime, or should be subject to a simplified regime. For example, we note specifically in Part II.D that it might make sense to consider the application of a "conversion regime" to a prepaid contracts that do not have unduly long terms. We suggest this as a possible alternative because the various regimes we discuss for taxing prepaid contracts are reasonably complicated, and for "safe harbor" contracts, any perceived inaccuracies of a simplified system might be viewed as acceptably small relative to avoiding the increase in complexity.

This report does not discuss in detail the question whether Treasury and the Service have the authority to implement regimes like those addressed in Part II, or to take any of the various other measures addressed in the Notice. However, as noted in our 2001 Report, there is a question whether Treasury has the authority under Section 446 or otherwise to implement an imputation regime. Indeed, this uncertainty might apply to any regime requiring the recognition of income or loss with respect to a contingent payment prior to the resolution of that contingency – which could even include a mark-to-market regime, at least in the case where later-included items are not permitted fully to offset earlier items. The reason is that these regimes can involve, or can be viewed as involving, more than simply the timing of items.[9] As an example (discussed further in Section II.A.1, below), an imputation regime may create items of income and loss that otherwise would never have existed.

II. Possible Regimes for Taxing the Time Value Component of Prepaid Contracts

This Part discusses several possible methods of taxing issuers and/or investors in prepaid contracts, and the pros and cons of each method. These methods address the "time value" component that is common to all prepaid contracts. There are other potential policy issues that can arise with certain kinds of prepaid contracts, including those that (i) are linked to "rebalancing" indices, (ii) pay periodic coupons, and/or (iii) "credit" investors with what would

[9] *See* Rev. Proc. 2002-9, 2002-1 C.B. 327 ("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. Comm'r*, 114 T.C. 587, 603 (2000) (same) (citing *Saline Sewer Co. v. Comm'r*, T.C. Memo 1992-236).

otherwise be ordinary amounts (*e.g.,* an interest factor or dividend amounts). We address these issues briefly in Part IV, although the Notice does not request comments on these issues.

As a cautionary note, we emphasize one major source of complexity, unfairness and potential for abuse in the tax system is the existence of multiple regimes for taxing economically similar positions or groups of positions.[10] We are concerned about this issue in connection with the possible implementation of a new regime. In other words, we think it very difficult to "deal with" prepaid contracts without systematically and comprehensively addressing all derivatives and similar instruments, or at least very carefully considering the consequences of the proposed solution in that broader context. We would be happy to work with Treasury and/or Congress in considering ways to overhaul the taxation of derivatives.

We analyze the various regimes for taxing prepaid contracts from the perspective of a variety of (often conflicting) policy objectives, including economic accuracy and fairness; the complexity and/or administrability of the regime; consistency and the possibility of electivity among regimes dealing with economically similar positions or groups of positions; and symmetry between issuers and investors and among categories of taxpayers.

A. Imputation

Under an imputation regime, a holder of a prepaid contract would be required to accrue income, in each year, based on the principal amount of the contract and some hypothetical interest rate. Conceptually, the idea would be to require the holder to recognize some income currently, to reflect a time-value return with respect to the amount of the prepayment on the contract. Imputation (whether of "interest" or of some other form of ordinary income) is the core of the proposal in our 2001 Report, and also of the Neal Bill. As a conceptual matter, we think imputing income (particularly interest) on prepaid contracts is generally appropriate. Any arm's-length arrangement involving a prepayment for goods or services has a time value component to it because the payor has parted with her money and will not receive the bargained-for consideration for some period of time.

However, there are several countervailing considerations. First, many "prepayments" are not currently subject to imputation (*e.g.,* the purchase price of

[10] Incongruities arising from line-drawing are difficult to avoid. For example, our 2001 Report proposed to draw a line between "ordinary" options and "long-dated" or "deep-in-the-money" options. Under that regime there is a line on either side of which very similar instruments would be treated quite differently. The same could be said of any "safe harbor" along the lines mentioned above.

stock, option premia; indeed, most broadly, the purchase price of any non-debt asset), while others are subject to differing forms of imputation (*e.g.,* the general original issue discount ("OID") rules; the specific OID regime for taxing contingent payment debt instruments (which we'll call the "CPDI rules"), Sections 1274 and 7872).[11] Thus, the implementation of a new and different form of imputation regime should be undertaken with caution, because any discontinuity in the treatment of economically similar positions or items tends to increase the complexity of the system, distort economic behavior and create possibilities for electivity and/or abuse.

In addition, imputation regimes create the possibility of "tax without cash." Although this can often be addressed (by structuring an instrument to provide for cash payments to pay the tax on the imputed income), some believe that the transactions costs (for both issuers and holders) involved in structuring these otherwise unwanted cash payments would be an unwarranted and inappropriate friction imposed on prepaid contracts by the tax law.

Finally, we note that imputation is not necessarily the "right" approach to prepaid contracts. Because a holder of a prepaid contract may lose money, the holder may never in fact receive the amounts imputed as income over the term of the contract. Imputation results in over-taxation of an instrument to the extent that the taxpayer ultimately receives back less than her initial investment plus the accrual. Even the CPDI rules don't purport to tax income "correctly" on an annual basis; they do so only in the aggregate over the life of the instrument.

It is without doubt possible, and broadly speaking, we think sensible, to view a prepaid contract as a combination of positions – and it is in that light that the case for imputation is strongest. Indeed, many have proposed that derivatives should be taxed in accordance with their basic "components."[12] However, two challenges significantly complicate any effort to disaggregate prepaid contracts: (i) it is well recognized that almost any derivative exposure can be replicated in more than one way, so there will always be multiple economically accurate sets of

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[11] Section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the regulations promulgated thereunder.

[12] *See, e.g.*, Reed Shuldiner, *A General Approach to the Taxation of Financial Instrument*, 71 TEX. L. REV. 243, 246 (1992) ("I recommend (1) that [financial] instruments be divided into their component parts and (2) that each component accrue income for tax purposes. . . ."); Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569 (proposing bifurcation as an ideal method of taxing financial instruments, but noting it would work only in the context of fundamental reform). *But see, e.g.*, Shuldiner, *supra*, at 289 ("To the extent the timing option remains, integrating related transactions has the benefit of reducing the opportunity for loss recognition on one part of a transaction while gain is unrecognized on another part of a transaction.").

components into which a prepaid contract can be disaggregated,[13] and (ii) disaggregation may produce complex sets of instruments that are themselves not easily valued or characterized.

To illustrate point (i), a simple prepaid forward contract to acquire some amount of the stocks in the S&P 500 Stock Index (the "S&P") (in their relative proportions as reflected in the S&P) can quite easily be thought of as a zero-coupon or OID loan to the contract's issuer, coupled with a "non-prepaid" forward contract to acquire the stocks in the S&P in the future, the "forward price" of which (which for actively traded assets like the S&P can be reasonably easily calculated, and is readily implied by prices in the futures markets) will be paid with the proceeds of the repaid "loan." Indeed, any prepaid contract can be thought of as a loan coupled with one or more other positions. However, this same contract could also be replicated by ownership of a portfolio of the stocks in the S&P coupled with a sale of (some or all) of the dividend and voting rights associated with those stocks over the term of the contract. These two sets of positions produce very different tax results.

To illustrate point (ii), a typical prepaid forward (broadly defined) issued in the capital markets today, might involve the investor paying $1,000 for the right in two years to receive $1,000 plus $1,000 times some multiple (say 111%) of the change in value of the S&P from inception to maturity (whether positive or negative), perhaps with a "buffer" providing that the investor does not suffer as the S&P declines until it declines more than, say, 10%. We refer to this prepaid forward as the "S&P Forward." In other words, the investor would receive $1,000 at maturity if the S&P had a value between 90% and 100% of its inception value, but would "enjoy" 111% of any increase in the value of the S&P (in addition to her $1,000) and "suffer" 111% of any decrease in the value of the S&P below 90% of its inception value (in the form of a reduction in her maturity payment); indeed, if the S&P were worth zero at maturity, the investor would by the terms of the contract be entitled to zero.

The S&P Forward is more complicated, economically, than the "simple" S&P forward contract described above, because of the increased participation in the appreciation in the S&P, and in the depreciation in the S&P below 90% of its value at inception. The S&P Forward can be thought of as the simple S&P forward contract plus (i) a 90%-struck written put option with respect to 111% of the S&P, (ii) a 100%-struck purchased call option with respect to 11% of the S&P, and (iii) a 100%-struck purchased put option with respect to the S&P. In general,

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[13] As a starting point, it is a fundament of finance that a share of stock is, economically, a combination of a written put option, a purchased call option and a loan. Thus, the basic economics of a call option on a share of stock can be replicated by borrowing money, purchasing the share, and buying a put option on the share, or by purchasing the share with nonrecourse debt. These three simple "groups" of economically similar positions are subject to materially different tax regimes under current law.

the "forward price" of the "non-prepaid" contract embedded in this S&P Forward cannot be easily determined.[14]

As both the "simple" forward and the S&P Forward demonstrate, taxing derivatives in accordance with their "components" requires overcoming significant conceptual and practical hurdles (and these instruments are both relatively straightforward as compared with many of the prepaid contracts being issued today). Additionally, we are skeptical that taking this approach to some derivatives but not others will be good for the tax system. Again, our concerns in this regard include the added complexity of the new regime, the risk that un- or underadvised taxpayers will be subject to less advantageous taxation than the well advised, and of course (and relatedly) the abuses that inevitably arise from "electivity" among materially different regimes for taxing economically similar positions.

1. Adjustments

Any imputation regime will also have to address the character of adjustments for over- and under-accruals of income over the term of the contract. Our 2001 Report expressed a mild preference for treating all such adjustments as capital in nature.[15] This approach would reflect a "pure bifurcation" perspective on prepaid contracts – that is, it would treat a prepaid contract as if it were a fixed-rate OID loan coupled with an entirely separate forward contract (which, if linked to one or more capital assets, generates capital gain or loss under Section 1234A of the Code). As a result, if the taxpayer's economic return is less than her accruals, she will have excess ordinary income (as compared to her economic return), with an "offsetting" loss that is capital, rather than ordinary, in character.

As an illustration, assume that the issuer's comparable yield is five percent, so that the loan implied by our S&P Forward compounds (annually) to $1,102.50 in year two. This implies that the "forward price" of the non-prepaid contract in our S&P Forward is $1,102.50. If the S&P at maturity is exactly where it was at inception, the investor will receive $1,000, a "net" effect of zero. Under an "all-

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[14]This is because (i) there is no active market for the analogous non-prepaid forward, and (ii) a forward price cannot be constructed from forward prices for the components because, in general, there will not be an active market for options (or forwards on options) with the precise strike prices needed to replicate the S&P Forward or a similar instrument.

It should be noted that the S&P Forward, like any prepaid forward, can also be disaggregated in other ways. For instance, the S&P Forward could also be thought of as (i) a $1,000 OID loan to the Issuer combined with (ii) an "at-the-money" purchased call option on $1,110 worth of the S&P and (iii) a 90%-struck written put option on $1,110 worth of the S&P.

[15] Our 2001 Report also noted that Treasury "could provide a rule where any losses would be ordinary to the extent of prior ordinary income inclusions, and capital for the balance," a concept that we refer to as "recapture" or "reversal" of prior inclusions.

capital" approach to adjustments, though, she will have accrued $102.50 of ordinary income over the two years, and will have a $102.50 capital loss at maturity. This is, indeed, the result that would obtain if a taxpayer lent $1,000 for two years on a zero-coupon basis at five percent per annum and separately entered into a two-year forward contract with respect to the S&P "struck" at 110.25% of its current value.

Of course, under this "all-capital" approach to adjustments as suggested in our 2001 proposal, the issuer would also be entitled to ordinary deductions for the imputed amounts and capital gain/loss for adjustments.[16] The consequence would be that, in this example, the issuer would have accrued $102.50 of ordinary deductions over the term of the contract and would recognize $102.50 of (capital) gain at the contract's maturity.[17]

While we think this is a reasonable method of taxing prepaid contracts, it is worth noting that (i) in any imputation regime involving "contingent" payments (including the CPDI rules), the issuer generally deducts currently as ordinary expense amounts it may never be required to pay, and (ii) we think any such regime will tend to distort economic behavior, as it will encourage U.S. taxpayers to issue these instruments and non-U.S. taxpayers to invest in them.

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[16] In general, the treatment of issuers of prepaid contracts is not likely to be particularly relevant in current practice because, to our knowledge, most prepaid contracts issued currently either are issued by dealers in securities that mark the relevant positions to market or are "variable prepaid forward contracts" that constitute a straddle with other positions the issuer holds. In either case, rules imposed on the issuer by virtue of its status would (absent some explicit exception) override the effects of any regime otherwise applicable to prepaid contracts. *See infra* note 17. Nonetheless, we think the treatment of a (perhaps hypothetical) issuer of a prepaid contract that is neither a dealer security nor a straddle position is conceptually relevant to the question of how these instruments ought to be treated.

[17] From the issuer's perspective, this is the equivalent of borrowing amounts from the government interest-free. As an ancillary matter, a "pure bifurcation" approach to these instruments would (assuming the mark-to-market or straddle rules do not apply) allow the issuer to enjoy a portion of its imputation benefit permanently, in the form of "conversion" of any unpaid net deduction into capital gain (or reduction of capital loss) on the settlement of the prepaid contract.

As discussed above, many issuers of prepaid contracts mark their positions to market as ordinary income/loss under Section 475. However, a "dealer in securities" cannot mark its own indebtedness to market, under Treasury regulations Section 1.475(c)-2(a)(2). It is not clear whether this rule would apply to any implied loan resulting from an imputation regime, although we see no pure policy reason why it should not (as opposed to the practical reason that, to our knowledge, securities dealers don't perform this kind of disaggregation for accounting purposes, which may make the process burdensome or unreliable). Additionally, many issuers of prepaid contracts are not themselves dealers, although they will often hedge their exposure via positions entered into with affiliated dealers; these issuers may not be marking their prepaid contract positions to market.

By contrast, the CPDI rules treat all positive adjustments as ordinary and negative adjustments as giving rise to ordinary deductions to the extent of prior ordinary inclusions. In our 2001 Report, we suggested that the CPDI rules should be modified to provide for the treatment of positive adjustments as capital, and we continue to support modification of that rule because these positive adjustments are clearly capital in nature, and unrelated to any conception of the cost of borrowing money. However, the CPDI rules' treatment of negative adjustments could also be viewed as appropriate, because allowing ordinary deductions to the extent of prior interest inclusions merely "reverses" the prior over-inclusion for the holder (and "recaptures" the over-deduction for the issuer).[18] Of course, this represents a "hybrid" perspective on the question of separating the components of the contract, which is equivalent to a view that the imputed interest is "contingent" rather than fixed (as it is from the pure bifurcation perspective).

The Neal Bill (discussed in Part V below) takes this "hybrid" or "contingent" approach to adjustments, treating negative adjustments as ordinary "recapture" to the extent of prior inclusions, while treating positive adjustments as capital. We agree with the Neal Bill's proposed treatment of positive adjustments as capital and strongly believe that the CPDI rules should be conformed.

We have, however, reached no consensus regarding the appropriate treatment of negative adjustments to the extent of prior inclusions in the context of prepaid contracts. Some of us believe it is reasonable to treat these amounts as ordinary losses, in light of the fact that a negative adjustment reflects the fact that imputed ordinary income was not ultimately realized. Others do not believe holders of prepaid contracts should receive better treatment than had they simply lent the issuer money and entered into one or more separate derivative positions, in which case interest inclusions on the loan would be ordinary but "adjustments" (in the form of gain/loss on the sale of the capital asset derivative(s)) would generally be capital.

2. Imputation Rate and Treatment

Another issue that would need to be addressed under an imputation regime is the rate at which to impute, as well as whether imputed amounts should be treated as interest. Our 2001 Report proposed imputation at the issuer's "comparable yield," which is consistent with the approach of the CPDI rules.[19]

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[18] Thus, in the example above, the CPDI rules would allow the taxpayer to treat the $102.50 loss as ordinary, "reversing" her ordinary inclusions during the instrument's term. Note that even then, the taxpayer has in essence "lent" money to the government interest-free, having paid tax that "ultimately" wasn't due, with no compensation for the time value of those payments.

[19] Presumably, the regime for prepaid contracts should import the same notions of an applicable federal rate ("AFR") floor and evidentiary burdens where investors are tax-indifferent as are imposed by the CPDI regime. *See* Treasury regulations Section 1.1275-4(b)(4)(i).

Moreover, most prepaid contract issuers currently are financial institutions, and these issuers can easily determine their comparable yields.

The Neal Bill, by contrast, proposes imputation at the short-term AFR, similar to Sections 1274 and 7872. This proposal has the virtue of simplicity, and also avoids the CPDI rules' evidentiary issues.

We tend to favor imputation at the issuer's comparable yield, as a matter of economic accuracy, notwithstanding its relative complexity as compared to AFR imputation. Because the AFR will generally be lower than the issuer's comparable yield, AFR imputation will generally result in holders recognizing less ordinary income over the term of the instrument than had they held debt of the issuer. This issue is all the more important if positive adjustments are treated as capital, as we have proposed, because in that event an AFR imputation regime would allow not only for deferral but also conversion of this differential into capital gain.

In any event, as we have mentioned, we recommend minimizing inconsistencies among regimes for taxing economically similar instruments – if AFR imputation is adopted for prepaid contracts, a conforming change should be made to the CPDI rules.

We recommend that any imputed amounts be treated as interest for all purposes, because we think that is the conceptual framework for imputing and compounding income (expense).[20]

B. Mark-to-Market

Under a mark-to-market ("MTM") regime, holders (and issuers) would recognize gain or loss periodically (typically, at the end of each tax year), based on the increase or decrease, over the period, in the value of any outstanding contracts. MTM is, by virtually all accounts, the most economically accurate method of measuring "Haig-Simons" income,[21] and is certainly available as a

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[20] We note, however, if negative adjustments are treated as ordinary "reversals" of prior inclusions, a case could be made that the imputed amounts are not, conceptually, being treated as interest.

[21] *See, e.g.* Terrence R. Chorvat, *Perception and Income: The Behavioral Economics of the Realization Doctrine*, 36 Conn. L. Rev. 75 (2003), David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111 (1986). *See generally* Robert M. Haig, *The Concept of Income – Economic and Legal Aspects*, in The Federal Income Tax pp 1 -28 (Robert Murray Haig, ed. 1921), Henry C. Simons, Personal Income Taxation (1938). We also note that an MTM regime would eliminate the "timing option" that exists under our current recognition regime, and some of the other proposals we are considering, whereby investors can accelerate losses by selling positions which have declined, but defer gains by holding appreciated positions indefinitely (or until maturity, in the case of prepaid contracts). It is worth noting that the policy implications of the timing option are less acute in the case of prepaid (...continued)

method of taxing exchange-traded or other readily valuable prepaid contracts. However, its efficacy is dependent upon (i) the ability of taxpayers to know the value of their positions with certainty at the time the positions are marked to market, and (ii) the inability of taxpayers easily to avoid or manipulate the regime (with respect to either particular instruments, *e.g.*, by taking them "off-exchange," or particular types or categories of instruments that may produce economically similar results to instruments subject to a MTM regime). It is well recognized that requiring taxpayers to mark some but not all of their positions to market creates complexity (*see, e.g.*, the "mixed straddle" rules) and uneconomic incentives (*i.e.*, to make valuation difficult or at least debatable), and allows the kind of electivity that facilitates potential abuses of the system.[22] And of course, MTM raises the issue of "tax without cash" to a potentially much greater degree than an imputation regime does.

It is true that most non-exchange-traded prepaid contracts are issued by financial institutions that are in any event marking their positions to market for accounting and tax purposes, and so could help their counterparties determine the contracts' MTM values. However, even when true this is not a panacea; witness the long-standing and still-unresolved debate between the financial institutions and the government over the propriety of GAAP valuation methods, including issues surrounding "aggregate" as opposed to "item-by-item" marking, bid v. ask spreads, and credit adjustments.[23] Thus, there may be reason to be skeptical that non-traded positions with financial institution counterparties can be reliably marked to market.

It may be that MTM is in theory the "best" regime for accounting for income, in the sense that it produces the fewest distortions.[24] However, we do not

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(continued...)

contracts, the final maturity dates of which limit the extent to which recognition of gains can be deferred. It is also worth noting that the effects of the timing option can be mitigated or eliminated by the imposition of an interest charge on deferred income, such as under the regime discussed in section 2.C, below.

[22] In this regard, the economic theory of the "second best" is instructive; often, a policy that would produce efficiency in an ideal world will turn out to be inefficient in the actual, "second best" world, because of how it interacts with other inefficient phenomena. While a MTM regime might produce efficient results if applied generally, in a world where some instruments are not subject to a MTM regime, taxing economically similar instruments under a MTM regime can increase dislocations and the potential for abuse. *See, e.g.*, Edward Kleinbard & Thomas Evans, *The Role of Mark-to-Market Accounting in a Realization-Based System*, 75 TAXES 788, 791 n.17 (Dec. 1997) (citing R.G. Lipsey & Kelvin Lancaster, *The General Theory of the Second Best*, 24 Rev. Econ. Stud. 11 (1956)).

[23] *See, e.g.*, Lee A. Sheppard, *News Analysis: IRS Resists Mark to Market*, 2008 TNT 107-7.

[24] To be clear, it does not follow that MTM is the best regime for *tax* accounting for income. Our realization-based system, and particularly the cash method of accounting applicable

(...continued)

believe that it makes sense to expand the current universe of instruments subject to MTM to include prepaid contracts unless and until all derivatives (and perhaps all capital assets) are subject to the same regime. An argument could be made for subjecting exchange-traded prepaid contracts to MTM, on the ground that we can do so (*i.e.,* that their value is generally provable), but we question this argument. First, we don't require MTM for all exchange-traded securities, even though their values can be readily established; instead, we restrict MTM (for non-dealers) to a narrow class of commodity-related assets that historically were subject to an actual system of marking to market (*i.e.,* cash withdrawals to pay taxes). Moreover, there's nothing tax-relevant that distinguishes exchange-traded prepaid contracts from other prepaid contracts in this regard (other than the ease of determining value), and the effect of such a rule would be that taxpayers might avoid exchange-traded contracts in favor of over-the-counter contracts, which would tend to favor wealthy taxpayers over others (as over-the-counter contracts are typically available only to high net worth investors).

If MTM were implemented for prepaid contracts, we believe that the character of items under the regime should generally follow the character of the underlying asset(s),[25] unless one wishes to repeal Section 1234A, and/or add to the complexity and electivity of the system.[26] A consequence of this (but, we think, a necessary one), is that amounts that might be viewed economically as "interest" will not be so treated – at least not without making the rule quite complex.[27] We do think it would be prudent to make clear that Section 1258 (or a similar rule) applies to ensure that debtlike instruments (*e.g.,* instruments linked to Treasury strips or accreting preferred stock, assuming for the sake of discussion that these are not in themselves determined to be debt instruments) are not entitled to capital gains treatment under an MTM regime.

(continued…)

to most items of individuals, are well grounded in the understanding that income and loss are not certain until reduced to cash and that the idea of tax without cash raises significant administrative, complexity and fairness issues.

[25] This will nonetheless result in some asymmetry (namely, a character mismatch) between issuers' and investors' treatment of prepaid contracts, where issuers are subject to ordinary MTM under Section 475.

[26] In general, we favor capital treatment on the sale or settlement of derivatives with respect to capital assets, for the very reasons that motivated the evolution of Section 1234A. The history of the elimination of the "extinguishment doctrine" has been one of unwarranted complexity and electivity, and we believe that Section 1234A reflects the congressional determination that those concerns should be resolved in favor of capital treatment for capital asset derivatives, whether on sale (or deemed sale, *e.g.,* with respect to marks to market) or settlement of such instruments.

[27] *See generally* Prop. Treas. Reg. Section 1.446-3(g).

That said, we see no reason to expand the scope of the "blended" 60/40 long-term/short-term capital regime of Section 1256, which was intended as a compromise for cleaning up perceived abuses in the commodity markets that to our knowledge no longer exist, and the policy basis of which at this point is far from clear.

C. Deferral with Interest Charge

Under a regime that allows for deferral of income recognition with an interest charge, a holder of a prepaid contract does not pay tax on the prepaid contract until disposition or maturity of the contract. However, at that point, the investor is taxed as if she had recognized income over the term of the contract, with an interest charge for the tax due on income allocated to prior years. Several existing regimes tax income from positions within their scope in this manner. This is the case (in slightly but meaningfully different ways) under Sections 1291 and 1260, for example.[28] These regimes, broadly, have an effect very similar to that of the CPDI rules – except that by virtue of the interest charge, they effectively treat *all* of the applicable income from the position as if it had accrued over the investor's holding period, not just the amount compounding at the issuer's "comparable yield" (in other words, these regimes effectively require that even "positive adjustments" be treated as if they'd been accruing over the investor's holding period). The trade-off for this is that these regimes do not require any inclusion to the extent that the investor ultimately has no net accession to wealth.

These regimes apply only to investors; no such regime exists for issuers. The difficulty with applying such a regime to issuers is that it would be difficult to identify an interest charge that would appropriately apply to the issuer's "deferred deductions."[29] However, if applied to issuers, such a regime would have the virtue, relative to an imputation regime, of not allowing the issuer a deduction before its economic loss is determined, in advance of "economic performance."[30] Additionally, these regimes resolve the problem of "tax without

[28] See the differences mentioned in note 31, below. In addition to those distinctions, Sections 1260 and 1291 operate differently in terms of how they impose their respective interest charges. For example, although both regimes achieve approximately the same net result, Section 1291 does not treat amounts allocated to prior years as income in the year of the disposition or "excess distribution," whereas Section 1260 does do so (other than for purposes of determining the amount of any tax credit and the alternative minimum tax).

[29] Again, this may not be a terribly important point in practice, because many issuers of prepaid contracts are subject to a MTM regime as securities dealers. If the issuer is subject to MTM and investors are not, however, the result system-wide is a tendency to misstate (and in the case of prepaid contracts, to understate) income. Thus, we think an important aspect of any method chosen to tax prepaid contracts, viewed from a broad fiscal perspective, is whether the method will "override" MTM regimes like Section 475.

[30] Section 461(h).

cash." However, they can cause materially distorted tax consequences relative to those that would have obtained under a current-inclusion regime.[31] Additionally, it is worth noting that these regimes currently have a fairly narrow scope of application; applying such a regime to all prepaid contracts would be essentially the same (*i.e.,* would have the same consequences in terms of complexity and electivity) as introducing an entirely new regime.

If a regime like this were implemented for prepaid contracts, we think it should apply to "recharacterize" as ordinary income and impose an interest charge on recognized gain only to the extent that it relates to "time value," while any excess gain should continue to be treated as capital. Indeed, ideally, the regime would impose an interest charge in accordance with the instrument's actual experience of increasing value, so as to avoid the distortion created when value attributable to the instrument's later periods is "imputed" to earlier periods or *vice versa,* although we do not think there is any realistic way of providing for this result. A similar result would be achieved by a MTM regime with a "cap" on the MTM equal to the then-accrued time value that has not yet been included.

D. Deferral with Ordinary Treatment for Accrued Time Value

Under a regime that allows for deferral of taxation, but taxes as ordinary amounts attributable to accrued time value (which we'll call a "conversion regime"), a holder of a prepaid contract recognizes income only at sale or maturity, but that income is treated as ordinary to the extent of the time value accrual with respect to the amount paid for the prepaid contract. The "market discount" rules of Sections 1276-1278 provide that (absent an election) taxpayers recognize accrued "market discount" (generally, the difference between a bond's adjusted issue price and its acquisition price) as ordinary income when, and to the extent that, they recognize gain. In other words, the market discount rules reflect the recognition that market discount is "like" interest (and thus is treated as ordinary income when realized), but is not interest (and so is not currently imputed unless the investor so elects). Similarly, Section 1258 taxes any gain resulting from a "conversion transaction" (very generally, a combination of positions substantially all of the return on which is expected to be time-value-based) as ordinary income to the extent of the compounded return on the taxpayer's investment (at 120% of the AFR). In other words, Section 1258 reflects a recognition that a portion of the return on some positions or combinations of positions is "like" interest (and thus is ordinary income when

[31] First, the interest charge under these regimes is punitive. Under both Sections 1260 and 1291, interest is charged at three percent above the short-term applicable federal rate (rounded to the nearest full percent). Sections 1260(b)(2), 1291(c)(3), 6601(a), 6621(b). Second, these regimes treat the ultimate income as earned "constantly" (on a straight-line basis, in the case of Section 1291, and on a constant-yield basis, in the case of Section 1260), even if in fact it was attributable to movements in the underlying assets during the earliest or latest days of the term of the instrument.

realized), but is not interest (and so is not currently imputed or subjected to an "interest charge" attributable to the deferral of its inclusion). Similarly, Section 483 provides for this same basic result (in a very different context) with respect to contingent installment sale payments.[32]

A conversion regime would, we think, address many of the concerns with other regimes we have discussed, but causes others. A conversion regime is reasonably easy to implement, does not result in tax without cash, and does not tax amounts that are never (or may never be) earned or incurred, much like the interest charge regime discussed in Part II.C. It reflects the notion that there is an "interest-like" component to the payout on a prepaid contract, but does not go so far as to treat that component (currently or via an interest charge "after the fact") as "interest" accruing during the term of the relevant instrument, thereby avoiding some of the negatives of an imputation regime, discussed in Part II.A, and of an interest-charge regime, discussed in Part II.C. Moreover, we think a conversion regime makes a great deal of conceptual sense as applied to issuers that do not mark their positions to market, given our general unease with providing deductions in advance of economic performance.[33]

On the other hand, a conversion regime allows investors to defer any income on their prepaid contracts (including any "time value" component thereof), and therefore would tend to distort their economic decisions as compared with, *e.g.,* CPDIs. Similarly, it is fair to observe that a conversion regime arguably tends to penalize "hypothetical" issuers discussed in note 16, above, who are neither dealers in securities nor holding their prepaid contract positions as part of a straddle, by deferring (and thus reducing the value of) their time-value deductions. Additionally, we recognize that a conversion regime would represent a new method of taxing a class of derivative instruments, which might carry with it the attendant concerns about complexity and electivity that have been discussed elsewhere.

One possible middle ground would be to apply a conversion regime only to prepaid contracts that are deemed worthy of a "safe harbor" from the otherwise-chosen regime, in the interest of simplicity and administrability. For example, a conversion regime might be applied to instruments with a term of, say, three years or less, that do not provide for periodic coupons, periodic crediting of interest or dividend amounts, or periodic "rebalancing" of index components.

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[32] Treas. Reg. Section 1.483-4(a) (treating a portion of certain deferred contingent payments under sales contracts as interest *when paid*).

[33] It is indeed hard to see the issuer of a prepaid contract as incurring an ongoing "cost of doing business," like servicing interest on debt, where it has no fixed obligation to (and may well never) pay any amount that could be considered "interest" – and on which it may by its terms *profit*, in the same sense it may profit from any position with respect to a capital asset.

As we discuss in Part IV, we do not believe that a conversion regime would be appropriate for instruments that periodically pay coupons or credit ordinary (interest or dividend) amounts. As for periodically rebalancing instruments, as we discuss in Part IV.A, we think instruments subject to objective rebalancings could be subject to a conversion regime (or other safe harbor).

E. Deferral with All-Ordinary Treatment

Another possibility would be to permit deferral of income/loss with respect to prepaid contracts, but provide that all items with respect thereto are ordinary. This would be similar to the application of Section 988 to a currency contract that is neither debt nor a swap and that is not subject to the MTM rules of Section 1256. One conceptual underpinning for such an approach might be that while prepaid contracts aren't very debt-like and may not easily be subject to a MTM regime, investors in these instruments should not both defer recognition and receive capital rates. A second basis for this approach might be that derivatives should not be entitled to preferential rates at all, as capital is not invested in the underlying asset(s) but in the derivative counterparty. Either of these conceptual arguments would be flatly inconsistent with the treatment of capital asset derivatives under Sections 1234 and 1234A.[34] While a proponent of these arguments might question the approach to capital asset derivatives, we believe that in light of the history of Sections 1234 and 1234A, any such regime should be implemented with respect to all capital-asset derivatives or none.

F. Deferral with All-Capital Treatment

A sixth approach would be to defer income/loss until maturity or sale, and then treat these items as capital (often called the "wait and see" approach). Wait and see is not dissimilar from the treatment of non-dividend paying stock, except that, in the case of prepaid contracts, *both* the issuer (if it is not subject to some other regime, like Section 475 or the straddle rules) and the investor can have capital gain/loss at maturity. It is true that many (but not all) issuers of these instruments are marking their positions to market, and that the prepayment will tend to cause these marks to reflect a component of time-value expense, which is not reflected in offsetting current inclusions by investors because investors do not mark to market. Accordingly, "wait and see" tends to generate the least amount of revenue over time and thus to provide the greatest distortion of economic decisionmaking. Moreover, wait and see is a particularly debatable approach to instruments that pay current coupons.

Again, while it may be viewed in practice as an economically inaccurate regime that tends to favor taxpaying investors, wait and see is the regime most consistent with our realization-based system of tax accounting (and particularly

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[34] *See supra* note 26.

the cash-method of accounting employed by individuals for most items of income and loss) and has in addition the virtues of simplicity and certainty. Thus, it might be viewed as appropriate to preserve this regime at least for prepaid contracts that are not unduly long-term, on the ground that there is not enough harm being done to the system to necessitate the complexity of one of the regimes discussed above.

However, we note that if and to the extent that a wait and see safe harbor (or a "conversion regime," as discussed in Part II.D) is adopted or preserved for prepaid contracts, we think it would be necessary specifically to address some of the issues discussed in Part IV with respect to certain types of instruments that would otherwise be subject to such a "simplified" regime.

III. Other Responses to Notice 2008-2

This Part addresses the specific questions raised by Notice 2008-2 regarding prepaid contracts.

A. Character of accruals (including adjustments)

As discussed in Part II, the question of character very much depends on the regime chosen for taxing prepaid contracts. We think an imputation regime should involve ordinary (generally, interest) treatment for imputed amounts, because this is consistent with the time-value theory under which such amounts would be imputed in the first place, and because it would avoid the potential electivity that could arise between this regime and the CPDI regime for imputation of income on debt instruments. Adjustments to imputed income upon sale or settlement, because they reflect the capital or risk-based component of the investment that produces them, should be treated as capital. However, to the extent of "recapture" of already-imputed amounts, ordinary treatment might be viewed as appropriate, as discussed in Part II.A, above.

We think that in general any income recognized over the term of a prepaid contract under an MTM regime should be capital in nature. This would mitigate potential planning opportunities utilizing prepaid contracts, and would also reduce electivity between prepaid contracts and other derivatives, which generally receive similar treatment under Sections 1234 and 1234A. However, again, we think a rule like Section 1258 would be needed to ensure that the regime does not permit "conversion" of very debtlike returns to capital gain.

B. Relevance of nature of underlying assets

Putting aside the applicability of Section 1260, discussed in Part III.E, below, and our discussion of "dynamic" underliers in Part IV, below, we do not believe that the treatment of a prepaid contract should turn on the nature of the

underlier(s), except to the extent that the underliers are (i) not capital assets or (ii) foreign currencies.

The taxation of prepaid contracts linked to foreign currencies is complicated under current law.[35] It would be helpful to provide clarification as to whether there is any concern with allowing taxpayers to "elect out" of Section 988 with respect to prepaid contracts.[36]

As for linkages to non-capital assets, this is an area of some uncertainty generally. It is not entirely clear whether Section 1234A applies to the settlement by terms of an instrument linked to an asset or index that is not a capital asset (or combination thereof). However, Proposed Treasury regulations Section 1.1234A-1(c) provides that gain or loss from the settlement of a forward contract or "bullet swap" (generally, a financial instrument providing for (i) settlement at or near maturity and (ii) the computation of amounts due by reference to a "specified index" upon a notional principal amount) is capital. While it is unclear what the term "specified index" is intended to mean, it is clear to us that without more, this provision is not limited by its terms to capital assets. This proposed regulation is proposed to be effective for contracts entered into on or after the date of publication.[37]

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[35] Again, we express no view on the line between prepaid contracts with respect to currencies and currency-linked debt, *see* Rev. Rul. 2008-1, 2008-2 I.R.B. 248, although we believe there is one.

[36] Section 988(a)(1)(B) provides that a taxpayer may elect out of Section 988 treatment with respect "to a forward contract, a futures contract, or option described in subsection (c)(1)(B)(iii) . . . ." Section 988(c)(1)(B)(iii) provides that "section 988 transactions" include "entering into or acquiring any forward contract, futures contract, option, or similar financial instrument." Two sources of uncertainty arise here: First, whether a prepaid currency contract should be treated as a "forward contract" or a "similar financial instrument" (many of them are extremely complicated instruments, as a result of which their status as a "forward contract" typically is less than clear) and second, whether a holder of a "similar financial instrument" may elect out of Section 988 treatment, or whether it is meant to apply only to forwards, futures, and options.

We think that taxpayers should be permitted to elect out of Section 988 treatment with respect to prepaid contracts, because they are "forward contracts." More specifically, they are not the kind of "similar financial instrument" that we think arguably was intended to be excluded from the election – those being debt instruments, "currency swaps," and "other notional principal contracts," all of which are explicitly dealt with elsewhere in the regulations. *See* Treas. Reg. Sections 1.988-1(a)(2)(iii)(B) (currency notional principal contracts generally), -2(b) (rules for taxation of currency debt), (e) (rules for taxation of currency swaps and other currency notional principal contracts), (h) (treating all amounts with respect to currency notional principal contracts as ordinary currency gain/loss).

[37] *See* Prop. Treas. Reg. Section 1.1234A-1(d).

It is not clear whether a prepaid contract would be characterized as a "bullet swap" under the proposed regulation, although we doubt it because we think it was intended that ***all*** payments under a bullet swap would be made at maturity. It is also not clear whether many prepaid contracts would qualify as "forward contracts," for reasons discussed in note 36 in connection with currency prepaid contracts. Nonetheless, we think that in the interest of avoiding the kind of "whipsaw" that Section 1234A was intended to prevent, it should be made clear that the settlement by terms of a prepaid contract that is itself a capital asset in the investor's hands – again, other than a "section 988 transaction" – produces capital gain or loss (after accounting for imputation or any other regime chosen for taxing the instrument on an ongoing basis), without regard to the nature of the underlying assets.[38]

C. Relevance of exchange-listing

As we have said, we see no tax policy basis for treating exchange-listed prepaid contracts like ETNs differently from other prepaid contracts. Indeed, we see little or no tax policy basis for the current "boundaries" of Section 1256, which treats some exchange-listed instruments differently *both* from other exchange-listed instruments *and* from economically similar non-exchange-listed instruments.

D. Section 7872

We believe that Section 7872 applies only to instruments that are indebtedness for U.S. tax purposes, and therefore we do not believe that Section 7872 applies to prepaid contracts. Section 7872 provides for imputation of interest on "below-market loans." The original legislative history states that for this purpose, the term "loan" should be construed broadly, though nonetheless limiting the term somewhat by noting that "any transfer of money that provides the transferor with a right to repayment may be a loan."[39] However, a later Senate

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[38] The question of how issuers (that are not subject to MTM) should be taxed on settlement of prepaid contracts generally is perhaps more debatable, as issuers can not "whipsaw" the government by assigning their obligations at a (capital) gain and holding them to maturity at an (ordinary) loss in the same way investors can. However, without regard to the nature of the underlying asset, we do not think it inappropriate to tax the issuer in the same manner as the investor – *i.e.,* to treat settlement gain or loss as capital.

There are several provisions of the Code that prevent the issuer of certain liabilities from obtaining *long-term* capital gain upon the settlement of that liability, *see, e.g.,* Section 1233, Section 1234B, Section 1234(b). We disagree with the policy judgment behind these provisions, *see* Tax Section, New York State Bar Association, *Report on Proposed "Straddle" Legislation*, reprinted at 2000 TNT 57-25, n.62, and do not think it should be expanded to include cash-settled derivatives

[39] H. REP. NO. 98-861, at 1018 (1984) (Conf. Rep.).

report accompanying modifications to Section 7872 states that Section 7872 is intended to apply only to "transactions that are loans for Federal income tax purposes." Again, we don't here draw the line between indebtedness and prepaid contracts; we (like the Notice) assume that the instruments in question are not indebtedness, and our discussion applies only to such instruments.[40] Thus, we do not think Section 7872 is helpful or relevant to the analysis.

E. Section 1260

It is clear that Section 1260 was not intended to apply to the broad universe of prepaid contracts, and that as drafted it simply cannot apply to many of them (those linked to commodities or currencies, for example). That is because Section 1260 applies to instruments linked to "pass-thru entities." Indeed, even ordinary corporate stock and debt are exempt from the scope of Section 1260 absent regulatory action. Moreover, Section 1260 applies to "constructive ownership transactions," which explicitly include instruments that are *not* prepaid, like notional principal contracts and "non-prepaid" forward contracts. Thus, Section 1260 clearly was not enacted to address prepayments or time value concerns. Indeed, the clear focus of Section 1260 was on actual or deemed "reinvestment" of income from passthrough entities, which for most prepaid contracts isn't in issue.

Clearly, Section 1260 as written could, by regulations, be applied to address prepaid contracts linked to ordinary corporate stocks or stock indices. However, that would not solve the problem of prepaid contracts, and would in our view be an arbitrary application of the rule – like exchange-listing, nothing about the linkage of some prepaid contracts to stocks or stock indices implicates the policy basis of Section 1260 in a way that's different from linkages to other asset classes.

That said, a regime like Section 1260 would undoubtedly eliminate deferral and "conversion," if that is the desired objective; indeed, it would almost certainly eliminate long-term prepaid contracts altogether (because, as discussed in Part II.C above, its consequences can be worse than simply holding the underliers). On the other hand, Section 1260 as drafted cannot handle many aspects of prepaid contracts – particularly those relating to actively rebalancing indices – because it assumes the contract's linkage to its underliers is static. This "flaw" in the regime can lead to wildly arbitrary results (which can be taxpayer-favorable) having nothing to do with what actually happened.[41]

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[40] *See supra* note 2.

[41] Section 1260 assumes taxpayers have a position with respect to a single "financial asset." It explicitly requires taxpayers to determine the long-term gain they would have had if they had acquired that financial asset at inception and sold it at maturity, and tells them that any gain they have in excess of that amount is "recharacterized." So assume that the taxpayer has a three-year prepaid contract with respect to an index (say, the "Dogs of the Dow," an index that (...continued)

The "concept" of using Section 1260 as referenced in the Notice is, we think, really about the idea of "looking through" the prepaid contract and "following" its underliers. This may achieve some desirable results for "rebalancing" or "crediting" indices (see Part IV.A, below), but for static baskets with "price-only" returns, we think it would do little or nothing to change current law.

F. Short-term prepaid contracts

Whether short-term prepaid contracts (*i.e,* those with a term of not more than one year) should be subject to the same regime imposed on long-term contracts is largely a matter of the perceived trade-off between conceptual purity and administrability/simplicity. In general, the issues raised by prepaid contracts generally are raised equally by short-term prepaid contracts; however, one can observe that there is in generally less "at stake" in this context. For example, short-term instruments will not generate long-term capital gain (absent Section 1256 or the "6-month future" rule of Section 1222). Also, there is very limited ability to defer anything with respect to short-term prepaid contracts, although avoiding an imputation regime even for one taxable year is a valuable benefit. Short-term debt is not subject to the CPDI rules, the OID rules or, if short enough, interest withholding tax, because the perceived benefits attainable through short-term instruments were not viewed as worth the complexity of attempting to eliminate them.[42]

G. Withholding

The issue of withholding in connection with derivatives is extraordinarily complex, as a conceptual/policy matter. In general, because withholding impedes the free flow of capital into the United States, we should be cautious in expanding the scope of withholding in connection with amounts paid on capital (other than

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tracks the performance during any year of the ten stocks in the Dow Jones Industrial Average with the highest price/dividend ratio at the beginning of that year) that "rebalances" entirely (ten "new" stocks) at the end of the second year, and the taxpayer sells the contract the next day. The statute as written might be read to suggest that the taxpayer must determine the gain she would have had if she had held for two years the ten stocks currently in the index – which have been there for one day – and compare that gain to her actual gain from the sale of the contract. That comparison, however, should not as a policy matter be relevant for purposes of Section 1260.

[42] The arguments for excluding "short-term" prepaid contracts (those with a term of one year or less) from any regime adopted to tax prepaid contracts generally are, of course, not (necessarily) the same as those for implementing a "safe harbor" from such a regime, although it would seem to make sense that any safe harbor exemption would apply (at least) to "short-term" prepaid contracts.

stock dividends and interest on bank loans), unless and until it is determined that our withholding regime should be modified significantly.

Analytically, interest imputation (which we generally favor, if imputation is imposed at all) would involve withholding only to the extent investors do not provide appropriate forms W-8BEN claiming the portfolio interest exemption or the benefit of a treaty. Even if imputed amounts are not treated as interest, it might be advisable to treat such amounts as not subject to U.S. withholding tax, for example on the ground that they are conceptually similar to notional principal contract payments.[43] MTM generally would not involve withholding, as gain is generally exempt from withholding tax. Absent a specific rule, the withholding tax implications of a regime that treats amounts as ordinary income (but not interest) on sale, settlement or marking to market would be more debatable under current law, but we believe these amounts should generally not be subject to withholding tax, even if treated as ordinary income.[44] Accordingly, we think it should made be clear that these amounts generally are not subject to withholding tax. However, specific issues relating to withholding in connection with credited dividend amounts are addressed in Part IV.C.

H. Sections 954 and 956

How Section 954 applies turns on the chosen methodology for taxing prepaid contracts. We think amounts recognized with respect to prepaid contracts are currently, and should be, treated as "foreign personal holding company income" (although whether as interest, "interest equivalents" or gain may be debatable in some cases). We are not aware of any use of prepaid contracts that can, or is intended to, avoid the application of Section 951.

As for Section 956, we think prepaid contracts should be treated as "obligations of" their issuers within the meaning of Sections 956(c)(1)(C), (c)(2) and (d). However, it is not unreasonable under current law to conclude that "obligations" for purposes of Section 956 include only evidences of indebtedness.[45] We would support guidance foreclosing this argument and clarifying that prepaid contracts are "obligations" for purposes of Section 956.

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[43] *See* Treas. Reg. Section 1.863-7 (treating swap income as either foreign-source or, if effectively connected, U.S.-source, but in either case not subject to withholding tax).

[44] For example, Section 1260 applies by its terms to everyone, and thus a technical question could have been raised whether foreigners' "recharacterized" ordinary income could be viewed as U.S.-source "FDAP." However, the legislative history specifies that the Section "does not apply to transactions entered into by . . . foreign taxpayers." S. REP. NO. 106-201, at 35 (1999) (Conf. Rep.).

[45] Treas. Reg. Section 1.956-2T(d)(2)(i) ("For purposes of § 1.956-2 . . ., the term 'obligation' includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness . . . ."). While this regulation says only that the term "includes" such things, which does not mean that prepaid contracts are not within the (...continued)

I. "Routine commercial transactions involving property sales in ordinary channels"

It is not entirely clear to us what is contemplated by this potential exception from the chosen methodology for dealing with prepaid contracts, although we assume the question is triggered by a similar exception to the "constructive sale" rules of Section 1259.[46] We are aware of no routine commercial prepaid contracts for the delivery of capital assets, and thus are skeptical that such an exception to any general rule adopted would be necessary.

As we have noted throughout this report, many taxpayers use prepaid variable deliver forward sale contracts as a method of hedging and monetizing their exposure to appreciated capital assets in a manner consistent with the constructive sale rules. This "type" of prepaid contract is generally very different from those being offered by financial institutions, but again, we see no need to treat it differently from other prepaid contracts for U.S. tax purposes.[47]

J. Other issues and similar arrangements

We address a number of other issues relating to certain types of prepaid contract in Part IV. We note also that any regime chosen for the treatment of prepaid contracts would need to deal with a variety of avoidance techniques and or electivity issues involving economically similar positions. For example, we assume that a combination of a call option and a "collateralized" put option, each with respect to the same (or a similar) index should be taxed like a prepaid contract. We also think consideration should be given to, for example, any differences in treatment between a prepaid contract and a collateralized nonprepaid contract with respect to the same index (or a nonprepaid contract coupled with a loan). Guidance may also be appropriate regarding whether and when positions structured with a view to avoiding the regime for taxing prepaid

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(continued...)

scope of the term, Treasury regulations Section 1.956-2(a)(1)(iii) defines "United States property" the tax basis of which is subject to inclusion under subpart F, to include "[a]n obligation *(as defined in paragraph (d)(2) of this section)* of a United States person. . . ." (emphasis added). The absence of instruments like prepaid contracts from the description of "obligations" could thus support a conclusion that a prepaid contract issued by a U.S. corporation to, or guaranteed by, its affiliated controlled foreign corporation is not "United States property."

[46] *See* Section 1259(c)(2), excluding from the application of Section 1259 any contract for the sale of an asset that is not a "marketable security" within the meaning of Section 453(f) and that has a term of one year or less.

[47] Indeed, it is almost invariably the case that issuers of prepaid variable delivery forward contracts would be precluded on a current basis from recognizing any imputed deductions or marked to market losses on their positions, under the "straddle" rules of Sections 1092 and 263(g).

contracts (structured partnership or trust interests, for example) should be subject to the regime. We also believe a great many straddle issues, currently applicable to a relatively small minority of taxpayers, may become more significant and in need of guidance depending upon the regime chosen.

IV. Issues Specific to Particular Types of Prepaid Contract

There are a number of issues relating to prepaid contracts that are not explicitly addressed by the Notice's request for comments. The Notice by its terms requests comments only with respect to a narrow class of prepaid contracts – those involving "an initial payment by one party in exchange for a promise of either (i) a future delivery of a particular asset or group of assets . . ., or (ii) a future payment determined exclusively by reference to the value of such assets." Thus, the Notice deals only with instruments referencing "static" baskets of "assets," and that do not make periodic or other payments by reference to anything other than the value of those assets.

In short, the Notice does not address instruments that pay periodic coupons (including instruments known as "mandatory" and "reverse exchangeables"), instruments with periodically "rebalancing" indices or instruments that periodically pay or provide credit for dividends or other income during the instrument's term. We think each of these categories of prepaid contract raises issues as to which the law is currently unclear and thus that, depending on what regime is adopted to address the "basic" prepaid contract issues, may need to be addressed by Treasury or other guidance.

A. Coupon-Bearing Instruments

Though their treatment under current law is far from clear, certain coupon-bearing instruments are commonly treated by the market as disaggregated into (one possible set of) their components. A typical "reverse exchangeable" may pay an above-market periodic coupon and, at maturity, the lesser of (i) $1,000 and (ii) the value of an amount of a reference asset that was worth $1,000 at issuance. Reverse exchangeables are commonly treated as debt plus a put option written by the investor to the issuer, where the periodic coupon is bifurcated into an interest component and a partial payment of the put option's premium. Only the interest component is taxed (or deducted) currently, while the aggregate put option is not accounted for until maturity or sale.

In the case of a "mandatory exchangeable," the investor typically will receive periodic coupon payments as well as a payment at maturity determined by reference to the value of an underlying asset. Typically, the investor will receive higher periodic payments than those that would be received by an investor in the underlying asset and, in exchange, will give up some of the appreciation on the asset (*e.g.*, all appreciation above 120% of the underlier's initial value), but bear the full downside risk of the underlier. An investor in a mandatory exchangeable

could, like an investor in a reverse exchangeable, be thought of as holding some combination of debt, options on the underlier (here, an at-the-money written put option, an at-the-money purchased call option, and a written call option struck 20% "out of the money"), with the periodic coupon bifurcated, again, into an interest component and a ("net") payment for the various option positions.

Without regard to how one determines to tax prepaid contracts generally, these and similar instruments raise an issue as to whether and how the coupons should be taxed, and whether they should be subject to withholding tax if earned by non-U.S. persons. Indeed, one might ask whether coupon-bearing instruments should be subject to a different regime from other prepaid contracts, although as a general policy matter we see no reason for this kind of line-drawing.

The Neal Bill proposes to tax coupon-bearing prepaid contracts like any other prepaid contract, and to treat coupons as nontaxable returns of capital (presumably on the ground that imputed income will have been accounted for already). If an imputation regime is adopted, we think this is generally a reasonable approach (although we discuss a possible exception in Part IV.C, below).[48] On the other hand, we think the market's current approach to many of these instruments (treating them as "disaggregated" into a coupon-paying bond and a separate set of options) is also a reasonable one, and that it accurately accounts for the instruments' economics – indeed, in effect the "disaggregation" approach produces the same basic results as the Neal Bill for many of the instruments in the market, although typically the market "imposes" currently taxable interest at something like the issuer's "comparable yield," while the Neal Bill would impute it at the short-term AFR, which is almost invariably lower.

A third possibility would be to treat these instruments as "notional principal contracts" ("NPCs"), even though prepaid.[49] Indeed, there is a reasonably strong argument that they meet the definition of an NPC contained in Treasury regulations Section 1.863-7. A consequence of this treatment would be that each of the coupons on these instruments would be treated (basically) as a

[48] Contrast the treatment of coupons under an MTM regime, where we think the answer would need to be very different. There, we think in order to achieve the objective of the regime, coupons paid in each year would need to be treated as part of the proceeds "deemed" received in that year for purposes of determining the consequences of the mark. A finer question could be asked whether a time value adjustment should be made for coupons received early in the tax year, though we are skeptical that any resulting increase in the accuracy of the regime would outweigh the incremental complexity.

[49] Under Treasury regulations Section 1.446-3, a prepaid NPC is treated as an NPC and a separate level-payment loan. *See* Treas. Reg. Section 1.446-3(f), (g)(4). We don't think this regulation applies to coupon-bearing prepaid contracts, under current law, because it seems to preclude from treatment as an NPC an instrument under which the notional principal amount is "borrowed or loaned between the parties as part of the contract." Treas. Reg. Section 1.446-3(c)(3).

currently includable/deductible ordinary item (either as a single periodic NPC payment or as a combination of an NPC payment and interest on the separate debt). However, we do not think this treatment is generally reflective of the economics of these instruments and so would be susceptible to significant abuses.[50] We also note that this would be a material disconnect from the treatment of economically similar non-coupon-bearing instruments.

In any event we believe that guidance is needed as to how to treat coupons on prepaid contracts, as there is a wide range of positions being taken by issuers of these instruments (particularly in the context of withholding) as a result of the existing uncertainty.

B. Rebalancings

Many prepaid contracts are linked to indices that periodically "rebalance." Indeed, even the S&P rebalances, although not periodically. Rebalancing is perhaps a more significant issue in connection with indices such as the Dogs of the Dow,[51] or the "BXM," which tracks a portfolio of the stocks in the S&P (with reinvestment of their dividend yield) plus the consequences of writing near-the-money covered call options on those stocks each month (so investors receive "credit" for call premium, which is notionally reinvested in the index, but little appreciation in the value of the S&P stocks). Other examples include indices of "rolling" forward or futures contracts with respect to commodities or currencies. Prepaid contracts tied to these sorts of "rebalancing" indices raise the question whether the instrument is or should be subject to taxation "as if sold" on one or more rebalancing dates, on the theory that a rebalancing of the underlying index is a taxable event (a "deemed exchange" of the old contract for a new one) under Section 1001.

Although there's very little law on this issue, generally practitioners are reasonably comfortable under current law that rebalancings that occur pursuant to an "algorithmic" formula specified in the contract (including rules or guidelines applied by a party unrelated to the prepaid contract) do not result in a deemed exchange, by analogy to the rules of Treasury regulations Section 1.1001-3. Under those rules, an alteration pursuant to the terms of a debt instrument is not a "modification" unless it changes the obligor of the instrument, causes the instrument to cease to be debt for tax purposes, or is a conditional option.[52]

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[50] For example, as mentioned, these instruments often have very high coupons, compensating the investor for, among other things, the risk of decline in the value of the underlier. Issuers would be happy to deduct these extremely high coupons (in the nature of put premium) currently, and many investors who seek taxable income (as we understand many regulated investment companies do, as well as entities with expiring losses) would be happy to include them.

[51] *See supra* note 41.

[52] *See* Treas. Reg. Section 1.1001-3(c)(1) and (2).

Nevertheless, the analogy to indebtedness is just that.[53] We are sensitive to the concern that deferring any recognition event until the sale or maturity of a prepaid contract allows a holder of a prepaid contract linked to an index to achieve a more beneficial tax treatment than if she had merely held the underlying assets or positions, in which case she generally would have recognized gain or loss on any rebalancing. Nevertheless, in the case of indices the components of which are determined on the basis of objective rules, we think it is reasonable to treat these contracts like other prepaid contracts.

More generally, if a regime like imputation, MTM or deferral with an interest charge is chosen to address time value issues, we do not believe that any additional regime would be needed to address such algorithmic or rules-based rebalancings. Once the "primary" issue with respect to prepaid contracts (deferral) has been addressed, we are skeptical that the incremental complexity that would be required to address ancillary issues like those arising from algorithmic rebalancings would be worth the effort. Indeed, any regime that attempts to address algorithmic rebalancings with respect to prepaid contracts would materially increase the complexity of the taxation of derivatives generally, because (we assume) it would necessarily implicate the treatment of instruments like bullet swaps, options and NPCs as well.

However, if a conversion regime were adopted, or if it were determined that wait and see is appropriate, we would recommend that this regime not apply to instruments linked to indices such as the Dogs of the Dow or the BXM that periodically rebalance, and that those instruments, instead, be subject to a regime requiring current recognition of income (at the very least to the extent of income that would have been recognized by a holder of the underlying(s)).

C. Dividend or Other Income "Crediting"

Many prepaid contracts (particularly ETNs) provide the investor with "total return" exposure to the underlying index, often including "credit" for interim dividends on underlying stocks and/or an interest factor. This raises a question whether these credited amounts are or should be treated differently from other components of prepaid contracts (including "coupons," as discussed above). For example, assume an instrument that pays periodically (say, each month) amounts equivalent to any dividends paid during the period on the instrument's underlying (U.S.) stocks. As a policy matter, these amounts probably should be

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[53] Moreover, in at least one circumstance – that of the change of insured under a life insurance contract – a modification by the terms of an instrument that arguably would not be viewed as a modification under Treasury regulations Section 1.1001-3 is viewed by the IRS and Treasury as a fundamental change in the instrument rising to the level of a taxable exchange. *See, e.g.*, Rev. Rul. 90-109, 1990-2 C.B. 191.

treated as if they were dividends, at least for purposes of withholding tax – although in fact there's very little to support this result under current law.[54] If instead these amounts are "notionally reinvested" in the index, with the holder of the contract having no right to elect to receive them currently as cash payments, so that they automatically become subject to the risks of the market for the remaining term of the contract, it is unclear how the "crediting" of them could be treated under current law as income to the investor, or as anything other than a component of the gain or loss resulting from the sale or settlement of the contract.

As in the case of rebalancings, discussed in Part IV.B, as a policy matter we do not believe that any special treatment is generally required with respect to the crediting of dividends or other interim income items, where a regime has been adopted to tax on a current basis (actually or synthetically, *e.g.,* via an interest charge) income from prepaid contracts. Indeed, credited amounts can easily be seen as merely a component of any such current taxation, and treating them specially would amount to double-counting.[55] However, we recommend that any other regime adopted for the taxation of prepaid contracts (such as a conversion regime or wait and see), or any "safe harbor" approach to the taxation of prepaid contracts that does not require taxation on a current basis, not apply to instruments that periodically credit interim dividends or other ordinary income, and that such instruments be subject to a regime that forces current recognition of (at least) those credited amounts.

However, if the regime adopted for taxing prepaid contracts generally does not impose withholding tax in connection with income earned by non-U.S. people (and generally, none of those discussed in Part II would do so), consideration might be given to whether this result should differ if the contract credits the investor with amounts that would have been subject to U.S. withholding tax if earned directly, such as U.S. dividends. In general we do not believe this is necessary absent significant changes in current law, because U.S. dividend equivalent amounts can currently be paid to non-U.S. people without U.S. withholding tax, *e.g.,* under debt instruments or notional principal contracts.[56] However, we recognize that this is a sensitive area. In particular, in

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[54] The "transparency regulations," including in particular Treasury regulations Section 1.861-3(a)(6), were promulgated in 1997 to ensure that amounts "equivalent" to dividends on U.S. equities earned by non-U.S. people under "securities lending" or "sale-repurchase" transactions are subject to withholding tax as if they are U.S.-source dividends. However, this regime would appear to apply only if, among other things, the underlying U.S. equities are transferred from the non-U.S. person to its counterparty at the inception of the transaction and back at the maturity thereof.

[55] We note that it might be viewed as appropriate to provide that any imputation regime tax annually "at least" any amounts of dividend or other income credited under the terms of the instrument, although we think this would be unnecessary if comparable yield imputation were adopted.

[56] *See* Section 871(h), Treas. Reg. Section 1.863-7.

the case of prepaid contracts that have economics substantially identical to the economics of owning U.S. stocks (*e.g.*, "total return" instruments linked to U.S. stocks or stock indices), we recognize that it might be viewed as appropriate as a policy matter to treat these instruments as subject to the "transparency regulations" of Treasury regulations Section 1.861-3(a)(6). However, while we would not oppose such an expansion of these regulations, we note that they are not applicable to typical prepaid contracts as they are currently drafted (because in a typical prepaid contract, none of the underlying securities is transferred by the investor to the issuer at the inception of the contract or by the issuer to the investor at the maturity of the contract, and no "substitute dividend payments" are made to the investor) and we therefore think any guidance in this regard, if any, should be effective prospectively.

V. The Neal Bill

This Part discusses specific, technical aspects of the Neal Bill that we think should be addressed if it progresses. The Neal Bill would require accrual of interest income at a specified rate (described below) on a "prepaid derivative contract" (described below), with basis adjustments. Loss would be treated as ordinary loss to the extent of prior accruals of ordinary income. Any excess of realized proceeds (including distributions, which are not otherwise taxable) over the investor's basis would be treated as gain. The imputation rate would be the short-term AFR (or, if greater, the rate at which notional amounts are credited under the contract), subject to a cap, in the case of publicly traded contracts, at the MTM annual value increase (with any excess carried forward). The provision would apply only to investors in prepaid derivative contracts, not to issuers.

A "prepaid derivative contract" would be defined for this purpose as an instrument (other than stock, debt, a "constructive ownership transaction," a hedging transaction, a notional principal contract or – unless the Secretary provides otherwise – an option) with a term to maturity of greater than one year, under which the investor generally has no further payment obligation, and that is linked to any security (as defined in Section 475(c)) or group of securities, any commodity (as defined in Section 475(e)) or group of commodities, or any "financial index." There would be exceptions for instruments that are either (i) held less than a year and sold before the unextended due date for filing the return for the year of acquisition or (ii) marked to market.

A. Rate issues

It's not entirely clear to us why the short-term AFR would be chosen as the rate at which to impute income under a prepaid contract. While simple as a matter of administration, it is unlikely to reflect the theoretical accretion of time-value based return on any instrument, because it does not reflect the yield-curve effect of being invested for the instrument's actual term or the "premium" implied by the issuer's credit risk.

The use of the issuer's comparable yield, as under the CPDI regulations, would more accurately capture the time-value component of the investment. This would also have the advantage of maintaining some consistency with the CPDI regime, and not multiplying imputation regimes under the Code.

In addition, it's not entirely clear to us what "credited under the contract" is intended to mean. The concept seems straightforward where there is explicit crediting of interest or dividend amounts; however, is the MTM value of an ETN "credited"? What about the unwind price of a notional forward rolled into another one, or the premium amount notionally reinvested under a BXM contract?

Moreover, as we've said elsewhere, we think the administrative convenience that might arise from treating publicly traded contracts differently from others with regard to the amount to be imputed under the contract is strongly outweighed by the needless discontinuities such differential treatment would create between otherwise identical instruments, which is not unlikely to distort behavior. Thus, if a regime similar to the Neal bill is enacted, we do not believe that imputation should be limited to the MTM increase in value of the contract.

Finally, while we agree generally that imputed amounts should be treated as interest, we think consideration should be given to the withholding tax and other consequences that can arise in connection with paying or crediting, *e.g.*, dividends or other withholdable amounts. (See Part IV.D, above.)

B. Scope issues

We think the term "financial index" should be defined. Without more, the term seems very broad,[57] but a broad reading of the term is inconsistent with (indeed, would easily "swallow up") the phrase "any security or group of securities or any commodity or group of commodities," which is quite (indeed, we think, inappropriately) narrow. We note that literally, an instrument linked to securities ***and*** commodities is not a prepaid derivative contract – unless the underliers are viewed as composing a "financial index." It is also unclear to us whether an instrument linked to a foreign currency is subject to the Neal bill. Is a foreign currency a "security" or a "commodity," as defined?[58] If not, is it a "financial index"?

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[57] *See, e.g.*, Treas. Reg. Sections 1.446-3(c)(2) ("specified index"), 1.446-3(c)(4)(ii) ("objective financial information"), 1.1001-3(c)(3)(iii) ("objective financial information"), 1275-5(c)(1) ("objective financial or economic information").

[58] While an analysis of this question is beyond the scope of this report, we do not believe the answer is at all clear.

Apart from these specific questions, we question why a regime like the Neal bill shouldn't apply to ***any*** prepaid contract not otherwise subject to taxation under some other regime (like Section 475 or the hedging rules of Section 1221(a)(7)).

C. What about the issuer?

As we proposed in our 2001 Report, we think an imputation regime for prepaid contracts should apply equally to both investors and issuers (subject to the potential application of other regimes, such as Section 475 or the straddle rules). As a general conceptual/policy matter, we question a regime that taxes the issuers and investors in a category of instruments asymmetrically as a general matter (*i.e.,* without regard to their particular circumstances or tax statuses). If the regime is to apply to issuers, then the bill should address whether imputed amounts should be treated as interest on a separate debt instrument for purposes of Sections 475, 861, etc.[59]

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[59] See supra note 17.