# News Analysis: Should Share Lending Affect a Prepaid Forward Contract?

by Lee Sheppard

**In news analysis, Tax Analysts contributing editor Lee Sheppard discusses the circulating excerpts of an unreleased IRS technical advice memorandum on prepaid forward contracts.**

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It's January, and Kate Moss is trying to revive her career by spoofing herself in a cellphone service ad -- "the contract you'll want to keep." Sienna Miller has promised to stop dressing like a hippie. Many of our women readers are looking at inane, faddish "in and out" lists in newspapers and fashion magazines. So we present our own highly opinionated, annotated list.

Some readers are no doubt wondering why in hell they should accept fashion advice from a grown woman who dresses like a suburban goth teenager and gives all her money to the guy who designed Madonna's pointy-bra stage costume. "The eye" -- as it is called in the fashion and design world -- that's why.

And don't take this too seriously. We're reminded of the Chicago woman whose New York stylist told her to get rid of her 400 St. John suits. That was wasteful and silly advice -- St. John suits are perfectly acceptable attire in the Midwest.

In: '80s Out: '70s

In: '40s Out: '50s

Oh, no, don't tell us the '80s are coming back! Actually, they've been sneaking back for a while, and you haven't noticed their little inroads. The '70s revival is over, but timid store buyers are afraid to acknowledge that fact. Just don't buy any more flared jeans or embroidered things or big ugly handbags with too much hardware on them. In many parts of the country, you can continue wearing this stuff for another two years.

What about the '40s? The '80s were basically the '40s with shorter skirts and brighter colors. The runways are chockablock with costumes that look like the Pointer Sisters' stage wardrobe. One aspect that is not coming back is shoulder pads. Many readers dread shoulder pads, but they are slimming and make the wearer look authoritative. Giorgio Armani, a favorite of many readers, has been putting big shoulder pads in jackets for his entire career.

But how can we endure a '40s-style belted suit with a pencil skirt and hose and high heels during an exhausting 12-hour day at the office? The only time a fashion designer spends 12 hours in a professional office is right after he has filed bankruptcy.

Aren't fashion editors women? Don't they think about comfort? Nope. Fashion editors spend long, grueling days pretending to work, writing frivolous copy, attending fashion shows, going to parties, cadging freebies, and sucking down Cosmopolitans while obsessing about their weight. They will freeze, sweat, pinch, and endure all manner of pain to wear the latest thing. They will wear shoes that are too big or too small just for the sake of having those particular shoes. *Absolutely Fabulous* is a documentary.

In: Waists Out: Midriffs

You know, in your heart of hearts, that at no time during the nearly decade-long period of the '70s revival was your administrative assistant in the same room with a slant board. She may, however, have had a tanning parlor paint on abdominal definition. (Are we making this up? *Elle*, January 2006, p. 88.)

In: Discretion Out: Melania Trump

We're not talking about the new Mrs. Trump's habit of wearing low-cut tops and high heels at all hours -- that's her job. We're talking about her practice of loading on the status symbols to the point of looking like a walking billboard for luxury-goods manufacturers. By discretion, we mean one status piece at a time, please. Wear less jewelry with that flashy bag, or a plainer bag with that fur.

In: Wedges Out: Stilettos

In: Round toes Out: Pointy toes

Unless your husband is a foot fetishist, confine the stilettos to cocktails. Put a pair or two in the office for those last-minute invitations when the shoes would dress up a business suit. If you feel compelled to slap on the four-inch heels with every skirt, think about shortening the hemlines instead, particularly if you are short.

In: Opaque hose Out: Bare legs

Many women readers feel compelled to wear flesh-colored sheer hose to the office -- or even worse, suntan-colored sheer hose. Flesh-colored hose are an abomination that should only be worn by professional ice skaters, drum majorettes, and the Dallas Cowboys Cheerleaders. We suggest semiopaque hose in the same color as the skirt or the shoes. If you've been wearing bare legs to the office, we have two words for you: Ally McBeal.

In: Drainpipe legs Out: Flared legs

Nothing dates a person faster than the wrong jeans. Get rid of the flares. You can keep the boot-cut jeans. Drainpipes are straight but narrower than boot-cut. The longer-term direction is toward cigarette legs, which taper all the way down to the ankle. No doubt they will be called something else so as not to refer to cigarettes.

In: Oversize coats Out: Princess coats

That will be good news to readers who wonder why they haven't been able to buy a coat that fits over a tailored suit jacket for a decade. Another bit of good news is that you can wear that old '80s trenchcoat again if you remove the shoulder pads and have the hemline shortened by eight inches.

Some of our readers are no doubt wondering what they're going to do to pay for their own or their wives' wardrobe overhaul, what with interest rates ratcheting up and house prices leveling off. Many rich folk whose wealth comes from a single issue of equity have monetized their gains through the use of prepaid forward contracts, which offer cash upfront while removing risk. Why don't those contracts violate section 1259, the toothless constructive sale rule? First, the government will not write implementing regulations for section 1259. Second, the government gave the green light to nonrecognition treatment for those contracts two years ago with Rev. Rul. 2003-7, 2003-1 C.B. 363, *Doc 2003-1634* [**PDF**] or *2003 TNT 12-13*.

But if the IRS gets its way in the prepaid forward contract technical advice memorandum that has circulated as far as business journalists, some rich women may have to resign themselves to last year's Manolo Blahniks. The memorandum states that the taxpayer must recognize gain on a prepaid forward purchase contract when the taxpayer will never have the identified shares returned because of a compulsory share lending agreement and behavior inconsistent with open transaction treatment. (For the memorandum, see *Doc 2006-74* [**PDF**].)

Will Wall Street beat back that ruling? That is thought to be the impetus for industry types to have floated it around. Wall Street is very good at scaring bureaucrats who have no experience with the financial markets. The flavor of that is in *The New York Times* coverage of the ruling, which vastly overstates the holding. (*The New York Times*, Dec. 30, 2005, p. C1.)

The financial markets, as Lord Keynes explained, run on emotion -- he called it "animal spirits." Treasury may be told, if it has not been already, that the equity markets will crash if the memorandum is not rescinded. Before the campaign to rescind it, there will be loud objections that careful practitioners make sure the form is perfect, the contracts are not explicitly linked, and the parties put on a good show of adhering to the form.

This is true, up to a point and that point is the point at which bankers' interests conflict with the niceties of the tax law. Lawyers can't baby-sit those deals, and bankers have a superseding responsibility to make sure that every position the bank has is hedged and every dollar of capital is being put to use. Banks can't be expected to sit on shares in which they have contractually assumed a long position. And they can be expected to charge more when they are asked to sit on shares.

**Reconstructing the Facts**

The memorandum is some particular taxpayer's ruling, so the excerpt that is floating around does not have the taxpayer's facts. The actual memorandum will be publicly released at the end of January. The IRS's discussion of the law is not an accurate reconstruction of the facts because some of the assertions about the facts made in the discussion are disputed.

Moreover, the important question is not the specific taxpayer's facts, but whether it represents a typical deal and typical behavior. The short answer is yes. Shares pledged in prepaid forward contracts are almost always borrowed by the investment bank that is the counterparty on the contract. The question is whether share borrowing causes a problem that causes the forward contract to fall outside Rev. Rul. 2003-7.

Investment banks don't want to talk to individual investors who are not "high net worth" individuals, but that doesn't mean that these investors warrant bespoke deals, as tax shelter investors of similar means discovered to their great disappointment. And yes, prepaid forward contracts are package deals. Prepaid forward contracts are low-margin, high-volume products pitched to individuals with net worth between $2 million and $5 million.

The taxpayer in the technical advice memorandum had several agreements with the counterparty, whom we assume for purposes of discussion was an investment bank. There was a forward purchase contract. There was a share lending agreement. There was a pledge agreement. All of the agreements were interrelated, were executed simultaneously, and covered the same identified shares.

The forward purchase contract allowed the counterparty to purchase a variable number of the taxpayer's identified shares on an agreed date in the future, while prepaying the taxpayer the purchase price in cash at a discount to reflect the time value of money. The IRS found that the discount also reflected the counterparty's ability to hedge its obligation under the forward contract. In this case, the taxpayer's cash settlement option had been deleted from the purchase contract. The counterparty had the right to accelerate the forward purchase contract if it could not hedge the shares.

The forward purchase contract required the pledge agreement, under which the taxpayer pledged the identified shares to secure his obligation to deliver the identified shares or identical shares at the date the forward purchase contract was to be settled. (A pledge agreement usually gives legal title to the shares to a trustee.) The pledge agreement said that the taxpayer retained voting and dividend rights to shares held in the collateral account -- that is, held as collateral for the taxpayer's obligation to deliver shares under the purchase contract. (Usually the number of shares pledged is the maximum number deliverable under the forward contract.)

The forward purchase contract and the pledge agreement required the trustee holding the identified shares to enter into the share lending agreement, under which the counterparty could borrow the shares for hedging or use them in its business as a dealer. The pledge agreement contained the taxpayer's preapproval of the share lending agreement. The counterparty did not have to post independent collateral under the share lending agreement -- as it would have had to do for a normal share loan -- because of the offsetting pledge agreement. The IRS description is disputed. The shares were borrowed, but were not, as the memorandum implied, borrowed immediately after being pledged.

The taxpayer had the right to terminate the share lending agreement and substitute identical shares. However, if the counterparty accelerated the purchase contract, it would have no obligation to return the shares under the share lending agreement. The counterparty could accelerate the purchase contract if it could not hedge its exposure under that contract. The IRS viewed that acceleration right as allowing the counterparty, rather than the taxpayer, to decide which shares were delivered under the purchase contract.

Moreover, the share lending agreement removed voting and dividend rights from the taxpayer. The taxpayer was supposed to get dividend equivalent payments, but according to the pledge agreement, the taxpayer was obligated to pledge additional shares to the counterparty when dividends were paid on the shares. The IRS found the taxpayer's dividend equivalent payments irrelevant. Here the IRS description is also disputed. The taxpayer retained the right to get the shares back for the purpose of voting them, whether or not he exercised that privilege. The pledge agreement provided for the shares to be voted.

The IRS found that the parties did not always respect the paper they had signed. The trustee under the pledge agreement was supposed to notify the taxpayer when the identified shares were lent to the counterparty. The IRS found a nearly yearlong delay between the counterparty borrowing the shares and the trustee notifying the taxpayer. Therefore the IRS concluded that the implementation of the share lending agreement required no affirmative action on the taxpayer's part.

Relying on *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981), the IRS considered all of the taxpayer's agreements to be part of "one whole, continuous transaction." The ruling hinges on the idea that the forward contract would not have been made had the taxpayer not agreed to lend the shares, and the forward contract would not survive a termination of the share lending agreement. The IRS characterization of that high degree of linkage between the contracts is disputed by many practitioners.

Does the precise degree of linkage matter? As this article will discuss, the question in nearly every prepaid forward contract is whether the fact of share lending matters to sale treatment. The extent of the linkage varies, as does the extent of the efforts of the investment banks' tax advisers to keep the contracts separate.

The IRS concluded that the bank had "acquired possession and unfettered use of the pledged shares." The IRS found that the taxpayer had no right to reacquire the identified shares once they had gone out under the share lending agreement. This characterization is disputed. The IRS believed that the counterparty's right to accelerate the purchase contract meant that it, rather than the taxpayer, had the right to decide which shares were delivered under the purchase contract. That is, even though the purchase contract allowed the taxpayer to deliver identical shares, the IRS believed that the counterparty had a hammerlock on the identified shares once they were in its possession.

**The Revenue Ruling**

So let's get back to Rev. Rul. 2003-7, the central giveaway in the individual monetization cases. The facts in the technical advice memorandum predated the revenue ruling. It was clear that two years earlier, few thought there would be a problem conditioning a purchase contract on share lending. The revenue ruling does not address share lending.

Rev. Rul. 2003-7 gives the investor a "bye" if the investor's facts fit the description. If they don't, the investor is fair game for being set up by IRS examiners. That is the face-saving way out for the IRS National Office lawyers who draft those things -- we didn't really give away the store, because some situations will fall outside the described facts. As investment bankers see it, the ruling stands for the proposition that there is no actual or constructive sale in a prepaid forward contract for a variable number of shares.

In Rev. Rul. 2003-7, the IRS ruled that the receipt of cash on a pledge of shares did not constitute a constructive sale of those shares if the taxpayer who pledged them retained the right to substitute collateral and is not economically compelled to deliver the pledged shares.

The ruling concerns a three-year variable delivery forward contract for publicly traded shares held by an individual. The counterparty to the contract was an investment bank. The taxpayer pledged the maximum number of shares that would be deliverable under the contract as collateral for the obligation to perform on the contract. The pledged shares were held by a third-party trustee. The taxpayer retained the right to vote the shares and collect dividends. The taxpayer was protected from downside risk of holding the shares during the term of the contract by the variable delivery formula, which collared a 25 percent range of prices.

The taxpayer received cash in an unstated amount. (In the usual case, the amount is the discounted present value of the maximum number of shares deliverable under the contract.) The taxpayer had the unrestricted legal right to satisfy the contractual delivery obligation by delivering the pledged shares, substitute shares of the same issuer, or cash. The ruling posits that the taxpayer "is not otherwise economically compelled to deliver the pledged shares." At the time the contract was made, however, the taxpayer intended to deliver the pledged shares.

Thus the IRS concluded in Rev. Rul. 2003-7 that the "transfer of actual possession of stock or securities and legal title may not itself be sufficient to constitute a transfer of beneficial ownership when the transferor retains the unrestricted right and ability to reacquire the securities." That is a polite fiction. The taxpayer has handed over his shares for a pile of cash -- which is not a returnable deposit -- but is not being required to recognize income on the off chance that he might get the shares back.

In ruling that no constructive sale had occurred under common law, the IRS relied heavily on the propositions that the taxpayer had the unrestricted right to reacquire the pledged shares by substituting cash or other shares and that the taxpayer was not economically compelled to deliver the pledged shares. The presence of a cash settlement option in the forward contract was important to the ruling.

As bad as it is, the ruling is arguably consistent with share identification. It explains why the taxpayer might not be considered to have sold the identified shares, but does not adequately explain why he gets to keep a lot of cash. Bankers analogize the cash to a loan, but note that documenting it as a loan would be impossible because a loan against customer shares would be a margin loan under Regulation T. Thus the loan amount would be limited to 50 percent of the value of the collateral -- rather more of a haircut than the monetization customer would tolerate.

Rev. Rul. 2003-7 contains factual outs. "A different outcome may be warranted if a shareholder is under any legal restraint or requirement or under any economic compulsion to deliver pledged shares rather than to exercise a right to deliver cash or other shares," Rev. Rul. 2003-7 states. The ruling elaborates that economic compulsion might exist if the taxpayer were broke or not permitted to hold the pledged shares after the maturity date of the contract. (For discussion of the outs, see *Tax Notes*, Feb. 3, 2003, p. 649, *Doc 2003-3129* [**PDF**] or *2003 TNT 23-10*.)

The taxpayer in the technical advice memorandum does not appear to have been under any economic compulsion to do anything. The requirement that the taxpayer deliver the identified shares was legal and practical in the IRS's view. As a practical matter, the counterparty wasn't going to give up the identified shares once it had them in its possession. But it is impossible for the IRS to prove that the taxpayer isn't going to get the identified shares back, ever.

As a legal matter, the IRS believed that the counterparty was entitled to keep the shares. The IRS believed that the purchase agreement and the pledge agreement were conditioned on the share lending agreement. The share lending agreement was the point of no return for the drafters of the memorandum, because they believed that it removed the remaining ownership rights from the taxpayer and allowed the counterparty to keep the identified shares. Another important factor was that the purchase contract had no cash settlement option, unlike the contract in Rev. Rul. 2003-7.

Even if the IRS prevails in the technical advice memorandum, there are messy audit questions. One is right there in the memorandum: How many shares should the taxpayer be deemed to have sold on day one of the contract? How should the contingency remaining in the contract be handled? That is a problem of foresight; the second question is hindsight. Since many three-to-five-year prepaid forward contracts were made during the technology boom, many contracts will have run their course with the customers having lent shares and not exercised rights to get them back. All the IRS auditors will have to go on is the paper documents.

How typical is the deal described in the technical advice memorandum? More typical than one would think, although the form has changed somewhat since Rev. Rul. 2003-7 was issued. There is a question whether the facts in the memorandum are egregious facts or middle-of-the-road facts. There is a view that industry types who circulated the memorandum might have worse facts than those posited in that document.

As a practical matter, shares pledged under prepaid forward contracts are borrowed by the investment banks that are the counterparties to those contracts. Sometimes it is necessary for the bank to borrow the shares, because they are thinly traded and it would be difficult to borrow them elsewhere. In the usual case, however, the shares are publicly traded, have a large float, and are widely available. Nonetheless, it costs the bank 20 basis points (hundredths of a percent) per year if it has to borrow shares to offset its obligation under the forward contract, and those 20 basis points will be coming out of the customer's hide.

So while no prepaid forward contract is conditioned on a share loan, the price paid always is. The discount applied to the purchase price for the customer's shares will reflect the time value of money and the cost of hedging against the long position -- that is, the cost of borrowing the necessary shares. Customers will usually be willing to lend their shares to maximize their cash and avoid this extra cost.

In the technical advice memorandum, the IRS believed that the forward contract was expressly conditioned on the share lending agreement -- that the former would not exist without the latter and would not continue if the latter were terminated. Bankers and practitioners insist that there is no "but for" issue or survival issue. A bank will sign a more expensive forward contract if the customer refuses to lend. A bank will not terminate a forward purchase contract if a customer has terminated a share lending agreement.

That being said, the agreements are not all that separate. Usually the forward contract and the share lending agreement are executed simultaneously and concern the same identified shares. Bankers are not too picky about separation of the contracts because this is a retail transaction, the shares will be borrowed anyway, and it is more convenient to just get it all done as a package. Bankers believe that the contracts can be analyzed separately for tax purposes even if they are not really separate.

Some lawyers go to great lengths to achieve separation. They might have the contracts signed on different days. They build a waiting period into the share lending agreement that says that the identified shares may not be borrowed for between 30 days and 90 days after they are pledged for the forward contract. Of course, this waiting period will affect the price of the forward contract. Some lawyers even ask that share lending be separately compensated, so that a customer gets paid separately if his shares are borrowed, or has to pay a separate fee to the bank if he does not consent to borrowing.

Can a customer refuse to sign a share lending agreement? Can a customer prohibit an investment bank from borrowing the shares? Yes, and very rich customers with conservative outside advisers have done so. Like everything else in banking, this privilege can be had for a price. That price is roughly 50 basis points per year on top of the discount for time value of money that is applied to the proceeds of the prepaid forward purchase contract. Not lending one's shares is expensive.

**Securities Lending**

Apparently the IRS had not previously spoken on the question whether a share loan accompanying a prepaid forward contract would qualify for section 1058, the special exclusion from sale treatment for loans of securities. Bankers believe that section 1058 and a 34- year-old revenue ruling separately protect any share lending that goes on in the context of a prepaid forward contract. To a banker, the collateral account that the identified shares go into is just like a margin account. Shares are routinely borrowed out of margin accounts.

Practitioners, however, have long viewed it as unlikely that a prepaid forward contract would qualify for short sale treatment, since the whole point of the contract is to reduce the taxpayer's risk of loss on the shares. As the bankers see it, a customer for a prepaid forward contract who is locking in appreciation still retains some downside risk. But in the ordinary lending situation, there is no risk reduction, only the convenience of the broker. A big institutional investor who lends shares to its broker does not do so to absolve itself of the risk of holding this position. It lends shares because it gets returnable collateral from the broker for doing so.

Back in the mists of time, the IRS issued a revenue ruling that must have seemed like a good idea at the time. Rev. Rul. 72-478, 1972-2 C.B. 487, said that share lending was not inconsistent with a short-against-the-box transaction. A taxpayer sells short against the box. His broker borrows identical shares in the market for delivery in the short sale. However, under the usual margin account contractual deal, his broker could have borrowed the taxpayer's very shares for delivery in the short sale. The ruling says that the short sale will not be considered a sale of the taxpayer's shares as long as those particular shares are not delivered to satisfy the short sale. The broker must have procedures in place to prevent this from happening.

So the 1972 ruling simultaneously adheres to the share identification requirement while recognizing the fungibility of publicly traded shares and the business necessity of share lending. The ruling says that it would not be inconsistent with the open transaction treatment of the short sale against the box for the short seller to have lent the shares, as long as those shares were used for something other than satisfying the short sale. In the context of prepaid forward contracts, bankers and their advisers believe that share lending is not inconsistent with the idea that the customer has not parted with the shares that are the subject of the contract. (For discussion, see Edward D. Kleinbard, "Risky and Riskless Positions in Securities," 71 *Taxes* 783 (1993).)

Reliance on section 1058 may not be assured. Section 1058 is a narrow exception to section 1001 that is intended to encourage share lending. It requires that the identified securities be returned to the lender, that dividends be passed through to the lender, and that the loan "not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred." The whole point to a prepaid forward contract is to reduce the customer's risk of loss, so section 1058 would appear to offer no protection if the contracts were linked. (Steven Rosenthal and Liz Dyor, "Prepaid Forward Contracts and Equity Collars: Tax Traps and Opportunities," *Taxation of Financial Products*, Winter 2001, p. 35.)

The taxpayer in the memorandum made a section 1058 argument. The IRS countered that the taxpayer would not get the identified shares back. Section 1058 requires that the lender of shares retain a significant amount of risk of loss and opportunity for gain, and, the IRS argued, should be narrowly construed. Because the taxpayer "has given up nearly all indicia of ownership" in the identified shares, and the lending occurred "nearly simultaneously" with the forward contract, it was "doubtful" that the taxpayer could regain possession of the identified shares without accelerating the forward contract, the IRS concluded.

If, as appears to be the position of the industry types who put the memorandum in circulation, a great many prepaid forward contracts suffer from the problem of linkage with share lending, then *The New York Times* may not be overstating the case. For those contracts, finding a sale on the basis of share lending might be tantamount to revoking Rev. Rul. 2003-7. If that is what the drafters meant to do -- assuming they recognized that a large portion of prepaid forward contracts would have a share lending problem -- why do it in technical advice?

Haven't we been through this before? Didn't a huge MIPS industry grow up around a technical advice memorandum that, legally, no one but the taxpayer was entitled to rely on? Didn't the Bush administration at least learn the lesson that guidance meant to guide Wall Street actions should at least be public? As bad as they were as policy and as legal interpretations, the contingent convertibles ruling and the feline PRIDES ruling were rulings that everyone was entitled to rely on. OK, go ahead and do this -- just do it this way.

A technical advice memorandum, which is approved by fewer of the same people who would be required to sign off on a revenue ruling, is a timid way of throwing things up against the wall to see if they stick. Yes, as this IRS recognizes, audit is a place for experimentation with positions. But the IRS National Office is supposed to be deciding what the position is for everyone. (Wall Street envisions a world in which the National Office just says no all the time to agents' efforts to collect revenue.)

Technical advice is not the appropriate place for sweeping new changes of position. Nor is it the appropriate place to address gaps in public guidance that were pointed out at the time. Indeed, there is a good argument that the position in the memorandum should have been accompanied by a revocation of Rev. Rul. 72-478. It should have been done as a modification and amplification to Rev. Rul. 2003-7.

The Law Is An Ass

How did we get here? How is it possible for rich people to accept a big pile of cash for shares they will never see again without paying tax? The problem isn't limited to Rev. Rul 2003-7, which can be fairly characterized as yet another sop to Wall Street. There are long-standing structural problems with the law that inertia (and the influence of Wall Street) prevents the best Congress money can buy from doing anything about.

Most of those structural problems are vestiges of a time when investors held physical securities in taxable form. The average investor -- the half of the population reported to own securities -- owns very little, and owns securities in the form of a tax-deferred retirement account. Any investor who puts on a prepaid forward contract is rich and not deserving of congressional sympathy, as the enactment of section 1259 demonstrated.

So here are the structural flaws:

*Realization requirement*. An anachronism that at one time reflected a genuine concern on the part of Congress about investor liquidity. Any investor who puts on a prepaid forward contract is, by definition, not illiquid, since the contract produced a big pile of cash from which tax may readily be paid.

David Miller of Cadwalader, Wickersham & Taft proposed a mark- to-market system to the President's Advisory Panel on Federal Tax Reform. He acknowledged concerns about driving investors away from publicly traded property and about valuing derivatives -- both problems the system already has. The corporate tax is a tax on publicly traded property, and fights about derivatives valuation are unavoidable but are being resolved. Moreover, Miller argues that many difficult rules -- like section 1259, the straddle rules, the wash sale rules, and section 1001 itself -- could be repealed. (For Miller's proposal, see *Tax Notes*, Nov. 21, 2005, p. 1047, *Doc 2005-22691* [**PDF**] or *2005 TNT 224-38*. For his testimony, see *Doc 2005-10238* [**PDF**] or *2005 TNT 91-75*.)

Miller would require individuals to mark to market both their gains at the current long-term capital gains rate of 15 percent and to deduct mark-to-market losses to the extent of gains. He would confine the mark-to-market requirement to individuals with high incomes or high net worth -- the richest one-tenth of 1 percent of the population -- the same as the registration-exempt purchaser under the securities law. Miller would confine marking to publicly traded property, derivatives on publicly traded property, and publicly traded debt. He would expand tax benefits for retirement savings of little investors.

Marking derivatives on publicly traded property to market would mean current taxation of monetization transactions like the ones discussed in this article. About the liquidity concerns that blocked other mark-to-market proposals, Miller argues that his chosen investors simply don't have that problem:

> Those taxpayers are fully capable of accessing their paper gains; for them, paper gains are actual cash. And only those taxpayers have access to financial products that defer or eliminate tax. Similar concerns were raised and cleared in the last major incursion on realization -- section 1259 -- when it was convincingly demonstrated that the proposal would affect only the wealthy.

If one of those rich investors had a prepaid forward contract, Miller's system would bifurcate it into a debt and a derivative, requiring the investor to accrue original issue discount on the prepayment discount. The derivative would be marked to market. The counterparty financial intermediary would be required to make the calculations. Without bifurcation, Miller argues, investors would still have an incentive to enter prepaid forward contracts, because of the present law's failure to tax the interest component.

A banker's-eye view of the situation is that share appreciation over the period of the forward contract must exceed the implicit cost of borrowing the prepaid proceeds. Viewed another way, the customer has assumed the downside risk that the shares will not appreciate as much as the implicit borrowing cost. But back in the technology boom, plenty of newly minted millionaires made bad deals. The law has not recognized the implicit loan component of those and similar transactions, but questions are being raised about it. (For discussion of the loan model, see *Tax Notes*, Mar. 4, 1996, p. 1411, *Doc 96-6391* or *96 TNT 46-62*; *Tax Notes*, Apr. 23, 2001, p. 564, *Doc 2001-11420* [**PDF**] or *2001 TNT 79-3*; and *Tax Notes*, Mar. 8, 2004, p. 1245, *Doc 2004-3663* [**PDF**] or *2004 TNT 46-50*.) Even the New York State Bar Association Tax Section has finally come around to the view that some accrual should be required on long-term options, prepaid forward contracts, and also deep-in-the-money options. (*See Doc 2001-9263* [**PDF**] or *2001 TNT 64-23*.)

*Share identification*. A vestige of the days when little old ladies kept share certificates under their mattresses and everyone who owned securities owned them in taxable form. Even then, share identification was not a good idea. The whole point of the public securities markets is that shares are fungible. Shareholders are allowed share identification as well as first-in, first-out as accounting methods for sales of shares bought at different prices.

The Clinton administration made a proposal nearly a decade ago to get rid of the share identification privilege. The Clinton administration proposed requiring taxpayers to take an average cost basis -- which holders of mutual funds already use -- in substantially identical shares, arguing that it would clearly reflect income. Short sales against the box would become taxable under this proposal. As a practical matter, average cost basis would simplify record keeping. Investors depend on their brokers to know their basis in the shares they bought. This proposal was none too popular with retail brokers, who like share identification as a tax reduction device for taxable holders with several blocks of shares. The brokers successfully fought off the average cost basis proposal. (For the proposal, see *Doc 96-8483* or *96 TNT 56-9*.)

*Constructive receipt*. Section 1259(d)(1), the constructive sale rule, defines a forward contract narrowly as "a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price." The House Ways and Means Committee report on section 1259 states that a forward contract that provides for "significant" variation in the amount of property to be delivered does not result in a constructive sale. Variable delivery forward contracts with significant variations would fall under the residual clause of section 1259(c)(1)(E). That clause requires implementing regulations, and those will never be issued. Although the revenue need for regulations is obvious, no such project is on the current business plan.

It's one thing to talk about an investor reducing the risk of loss by putting on a collar. There is an argument about whether that investor has parted with anything, and that investor certainly hasn't got a pile of cash. An investor who puts on an equity swap has made an exchange of shares for whatever is the reference portfolio on the other side, but that investor still hasn't got liquidity. Those investors should be deemed to have made a taxable exchange of shares for something of value under section 1259, which, readers will recall, was watered down into irrelevance by complaints from Wall Street.

An investor with a prepaid forward contract, however, has a pile of cash. There's no "constructive" to be discussed; Rev. Rul. 2003-7 and the technical advice memorandum describe cases of actual receipt. As a matter of law, any big outlay of cash that is not a returnable deposit ought to be taxed immediately, but the giveaway would have been marginally worse had this been a revenue procedure.



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### Tax Analysts Information

**Code Section:** Section 1259 -- Appreciated Financial Positions; Section 1058 -- Securities Transfer Agreement
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