

June 9, 2009

Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224
Attn: CC:PA:LPD:RU (Notice 2008-2)

Dear Sir/Madam:

On behalf of the Securities Industry and Financial Markets Association (SIFMA),¹ I am pleased to submit the attached comments on Notice 2008-2 concerning the timing, character, source and other issues respecting prepaid forward contracts and similar arrangements .

Thank you for your consideration of our views. Please do not hesitate to contact me (at 202-962-7326 or pmcclanahan@sifma.com) or Erika Nijenhuis of Cleary Gottlieb Steen & Hamilton LLP, SIFMA's outside counsel on this matter (at 212-225-2980 or enijenhuis@cgsh.com), if SIFMA can be helpful in any way as you proceed with your work in this area.

Sincerely,

<<Signature Removed>>
Patricia McClanahan
Managing Director, SIFMA

Cc: Karen Gilbreath Sowell
Steve Larson
David Shapiro
Mike Novey
John Rogers

¹ The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.



SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

SUBMISSION IN RESPONSE TO NOTICE 2008-2 REGARDING
TREATMENT OF PREPAID FORWARD CONTRACTS

JUNE 9, 2008

TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION	1
A. Notice 2008-2	1
B. Summary of Our Submission	3
1. Taxpayers invest in prepaid forward contracts because of the investment opportunity they offer	3
2. Current law rules for prepaid forward contracts are based on fundamental U.S. tax principles.....	4
3. None of the proposed alternatives would be better than current law either as a policy matter or as a practical matter ..	5
4. Current law's tax treatment of prepaid forward contracts is appropriate	6
II. PREPAID FORWARD CONTRACTS.	7
A. What is a Prepaid Forward Contract?	7
B. Reasons to Invest in Prepaid Forward Contracts.....	11
C. Development of Prepaid Forward Contracts	15
III. CURRENT TAX LAW ANALYSIS OF PREPAID FORWARD CONTRACTS	20
A. Characterization of Prepaid Forward Contracts as Non-Debt Derivative Financial Instruments.....	20
B. Taxation of Investors in Prepaid Forward Contracts Under Current Law	26
1. In general	26
2. Treatment of periodic payments.....	29
3. No imputation of interest income	31
IV. CURRENT LAW IS THE BEST APPROACH	33
A. Current Treatment Is Based on Fundamental Tax Principles	33
B. Departures From the Realization Principle Are Narrow	38
1. Constructive receipt	39
2. Original issue discount, CPDI and NPCs	41
3. Section 1256; mark-to-market.....	47
4. Section 1260 and passive foreign investment corporation rules	49
C. Any Alternative Should Be Better, Not Just Different	51

TABLE OF CONTENTS (continued)

V.	POSSIBLE ALTERNATIVE REGIMES.....	53
A.	Mark-to-Market	57
B.	Look-Through Approaches	58
1.	Summary of look-through approaches	58
2.	Problems with look-through approaches	59
C.	Accrual of Deemed Interest	65
1.	Arguments advanced in favor of accrual	65
2.	Responses	66
(a)	Embedded debt	67
(b)	The second-best approach argument.....	70
D.	Redefining Debt Generally.....	75
VI.	POSSIBLE WAYS TO DRAW LINES BETWEEN INSTRUMENTS.....	77
A.	Long-Dated vs. Short/Medium-Dated.....	77
B.	Exchange-Traded vs. OTC Instruments.....	81
C.	Total Return Economics vs. Price Return	82
D.	Degree of Riskiness of Underlying Assets	83
	ANNEX A – EXAMPLES OF STRUCTURED PRODUCTS TREATED AS NON-DEBT TRANSACTIONS	86

SUBMISSION IN RESPONSE TO NOTICE 2008-2 REGARDING
TREATMENT OF PREPAID FORWARD CONTRACTS

I. INTRODUCTION.

A. Notice 2008-2.

On December 7, 2007, the Treasury Department (“Treasury”) and the Internal Revenue Service (the “IRS”) issued Notice 2008-2 (the “Notice”),¹ which requests public comments on a comprehensive list of tax policy issues raised by prepaid forward contracts that do not constitute debt instruments under current law. We are pleased to submit the comments of the Securities Industry and Financial Markets Association (“SIFMA”)² with respect to the Notice. These comments were prepared by the SIFMA Committee on the Federal Taxation of the Securities Industry.

The Notice defines “prepaid forward contracts” as transactions that “typically involve 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 (for example, stocks or commodities), or (ii) a future payment determined exclusively by reference to the value of such assets.” This definition includes both instruments traded on a stock exchange, generally referred to as “exchange traded notes” or “ETNs”, and instruments that are

¹ Notice 2008-2, 2008-2 I.R.B. 252.

² The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

sold over the counter. Recent Congressional testimony by a senior Treasury official indicates that some perceived differences in the structure and distribution of ETNs as compared to over-the-counter (“OTC”) prepaid forward contracts, specifically the fact that ETNs are more readily available to retail investors, were a motivating factor in issuing the Notice and reviving the government’s interest in considering the core tax issues presented by prepaid forward contracts.³

The Notice states that the Treasury and the IRS “are considering whether the parties to a [prepaid forward contract] should be required to include income/expense during the term of the transaction,” assuming the transaction is not otherwise already properly classified as debt under current law. The Notice suggests that the Treasury and IRS are considering several possible approaches to achieve a current accrual regime, including:

- (i) adoption of a mark-to-market methodology;
- (ii) expansion of the current accrual regime currently applicable to contingent payment debt instruments (“CPDIs”);
- (iii) adoption of regulations that would categorize prepaid forward contracts more generally as debt instruments; and
- (iv) treatment of prepaid forward contracts as “constructive ownership transactions” under section 1260⁴ (in which case the transactions would not actually be taxed on a current basis, but the investor would be required to pay an interest charge in respect of certain deferred income).

In addition, the Notice requests comments on the “appropriate character (capital vs. ordinary, and if ordinary, whether interest) of any income accruals required [under a current accrual regime].”

³ See Prepared Testimony of Treasury Tax Legislative Counsel Michael Desmond Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, *Hearing on Tax Treatment of Derivatives*, March 5, 2008 reprinted in *2008 Tax Notes Today* 45-52 (Mar. 10, 2008) (hereinafter the “Treasury Testimony”).

⁴ Unless indicated otherwise, all section references are to the Internal Revenue Code of 1986, as amended, or to Treasury regulations promulgated thereunder.

The Notice requests comments on “[w]hether the tax treatment of the transactions should vary depending on the nature of the underlying asset (for example, stocks vs. commodities);” and “[w]hether the tax treatment of the transactions should vary depending on whether the transactions are (i) executed on a futures exchange (and are not otherwise subject to section 1256 of the Internal Revenue Code), or (ii) memorialized in an instrument that is traded on a securities exchange.”⁵

B. Summary of Our Submission.

1. Taxpayers invest in prepaid forward contracts because of the investment opportunities they offer.

- Prepaid forward contracts are a large and important class of financial instruments. ETNs are a subset of prepaid forward contracts.⁶
- Many prepaid forward contracts offer financial opportunities different from investing in the underlying assets directly. For example, they can provide synthetic exposure to asset classes or sophisticated investment strategies that investors would otherwise have difficulty accessing for a variety of practical and other reasons. This is true of all types of prepaid forward contracts, including ETNs.⁷
- Some investors in prepaid forward contracts are taxed less favorably compared to a hypothetical direct investment in the underlying assets. For example, current distributions that economically represent dividends or an option premium are generally treated as ordinary income that is not tax-favored. Some prepaid forward contracts are taxed in a manner that is more favorable than a hypothetical direct investment in the underlying assets, and others have a tax treatment

⁵ The Notice also raises a number of ancillary tax policy questions (such as the application of the subpart F rules to prepaid forward contracts), the answers to which depend on the overall approach adopted in taxing prepaid forward contracts. We believe that the core issues raised by the Notice should be addressed before considering such ancillary matters. We would be pleased to provide comments to the Treasury and IRS on those matters at such future time.

⁶ In this submission, we use the term “prepaid forward contract” to refer to the universe of transactions of the kind described in Notice 2008-2, and we use the term “ETN” to refer generally to long-dated prepaid forward contracts that are very actively traded on an exchange. According to NYSE Euronext, a prepaid forward contract must be redeemable at least on a weekly basis in order to be considered an ETN for purposes of the exchange. As discussed in more detail below in Section III.C, prepaid forward contracts in general have been listed and traded on exchanges since the early 1990’s, at various levels of trading activity. However, recent press reports have used the term “ETN” to refer only to the subcategory of products that are very actively traded. Because this terminology has become common, to avoid confusion we use the same terms.

⁷ Annex A contains a number of examples of different kinds of prepaid forward contracts.

that may be more or less favorable depending on the performance of the underlying assets, which cannot be predicted.

- As these differences in tax treatment demonstrate, investors generally choose prepaid forward contracts because they meet a variety of important financial needs unrelated to tax considerations.
2. Current law rules for prepaid forward contracts are based on fundamental U.S. tax principles.
- Current law generally taxes investors in prepaid forward contracts according to the *realization principle*, which means that no tax is paid on uncertain future returns until investors actually receive such returns or become unconditionally entitled to receive them in the future. Accordingly, under current law, investors generally are advised that they have current taxable income to the extent of any distributions to them on a prepaid forward contract, but are not subject to tax on any phantom income.
 - The realization principle is not merely a default option. It is based on fundamental tax policy concerns about taxing income that is *impermanent*, *difficult to value*, and *illiquid* (because there is no corresponding cash).
 - o *Impermanence*. Until the returns on a prepaid forward contract are received or become fixed, any increase in value is impermanent. The payout on a prepaid forward contract generally is linked to a stock, commodity, or other risky asset, and consequently the prepaid forward contract itself is fundamentally a risky investment. Investors in prepaid forward contracts do not have the right to receive any specific return on their investment and may lose all or a very substantial part of their investment.⁸
 - o *Valuation*. Most prepaid forward contracts are not actively traded on an exchange. Consequently, valuations of many prepaid forward contracts could be subject to challenge.
 - o *Illiquidity (lack of cash)*. If an investor in a prepaid forward contract were required to pay current tax on phantom income — whether in the form of accruals of non-existing “interest,” or annual recognition of ephemeral “gains” — the investor would potentially be forced to dispose of its investment solely to pay

⁸ Since its launch in June 2006, for example, the Barclays Dow Jones – AIG Commodity Index Total ReturnSM ETN has varied in price from under \$46 to over \$67. In the last few months alone, its price has both risen by about 10 percent and fallen by about 10 percent, more than once. For the prospectus, see Barclays Bank PLC, Prospectus, \$3,000,000,000 iPath® Dow Jones–AIG Commodity Index Total ReturnSM ETN, due June 12, 2036, available at <http://www.ipathetn.com/pdf/djp-prospectus.pdf> (hereinafter the “Barclays Dow Jones – AIG Commodity Index Total ReturnSM ETN”)

the taxes on that income. A requirement of this kind could distort investment behavior.

3. None of the proposed alternatives would be better than current law either as a policy matter or as a practical matter.

- As a tax policy matter, the proposed alternatives for taxing prepaid forward contracts are not better than current law. All of the suggested alternatives, such as accrual of deemed interest, “look-through” regimes, and mark-to-market, would violate some or all of the tax policy concerns about impermanence, illiquidity, and valuation difficulties. It is telling that there are currently very few and limited exceptions to the realization principle.⁹ These exceptions apply to situations and instruments that are materially different from prepaid forward contracts. We do not believe the policy reasons advanced for departing from realization-based treatment for investors in prepaid forward contracts are compelling.
- Many of the proposed alternatives would be unworkable as a practical matter. In some cases, they would be far too complex. In other cases, they would be so onerous that they would effectively eliminate prepaid forward contracts as a widely available form of investment.
- In evaluating any potential new rules for prepaid forward contracts, we recommend that Treasury and the IRS be guided by the following four basic principles:
 - *Clarity.* Any new rules should be as clear and unambiguous as possible.
 - *Consistency.* Any new rules should apply a consistent set of principles and implementing rules to different types of financial instruments that have similar economic and financial features. In particular, any new rules for prepaid forward contracts should be harmonized with the rules for other financial instruments that provide for contingent payments – in particular, contingent debt and swaps with contingent payments. Otherwise, adding yet another new separate tax regime is bound to create at least as many tax policy and practical issues as it may solve.
 - *Administrability.* Any new rules should be readily administrable by the IRS and understandable by investors. Information reporting rules should be updated and should allow brokers to make reasonable simplifying assumptions when providing information to investors.¹⁰

⁹ Section IV.B, below, discusses some current tax rules that depart from the realization principle, such as the rules for OID.

¹⁰ See, e.g., Treasury regulation section 1.6049-5(f) (permitting brokers to treat all customers as original rather than secondary market purchasers for purposes of reporting amounts of OID).

- *Balance.* The new rules should strike an appropriate balance between consistency with the taxation of the assets referenced in derivative contracts and recognition that financial derivatives are complex instruments that do not merely represent “laundry tickets” to the underlying assets.¹¹
 - None of the proposed alternative methods to current treatment of prepaid forward contracts would meet all of these standards.
4. Current law’s tax treatment of prepaid forward contracts is appropriate.
- Taxing investors on phantom income when they may never see that income and in fact may well lose money is a fundamental policy choice that the law today rejects.
 - Taxing investors on phantom income would not take into account that investment in a prepaid forward contract is different from an investment in the underlying assets. By entering into a prepaid forward contract, an investor acquires an indivisible package of risks which cannot be separated as a practical matter and over which the investor has no control.
 - Taxing investors on phantom income could result in tax treatment that is *worse* than the tax rules that apply to a direct investment in underlying assets or in shares of mutual funds. That would “solve” one perceived problem by creating another.
 - Taxing investors on phantom income therefore could distort investment decisions that should be made on the basis of an evaluation of economic returns.

Part II, below, provides an overview of the market for prepaid forward contracts. Part III discusses the prevailing consensus about the current tax rules applicable to investors in prepaid forward contracts. Part IV then describes the reasons

¹¹ The Treasury and IRS have recognized the importance of adhering to similar principles in crafting new rules for taxation of financial instruments. See Notice 2001-44, 2001-2 C.B. 77 (requesting comments on potential methods of accounting for notional principal contracts (“NPCs”) with contingent nonperiodic payments). The Notice states:

[Fundamental tax] policy principles include: whether the method provides sufficient certainty as to the amount and timing of inclusions or deductions (certainty/clarity); whether the method is complex, and the compliance and administrability burden created by that complexity (administrability); whether the method creates or increases inconsistencies in the tax treatment of financial instruments with similar economic characteristics (neutrality); whether the method creates or increases inconsistencies in the tax treatment of different taxpayers entering into the same instruments (symmetry); whether the method accurately reflects the accretion or reduction in economic wealth in the period in which the taxpayer is measuring the tax consequence of being a party to the NPC (economic accuracy); and whether the method is flexible enough to readily accommodate new financial arrangements (flexibility).

why we believe that current law should be retained. Part V discusses the possible alternative tax rules suggested by the Notice, as applied to all prepaid forward contracts, and Part VI considers the possibility of applying new rules to a subset of prepaid forward contracts that have particular economic and financial features.

II. PREPAID FORWARD CONTRACTS.¹²

A. What is a Prepaid Forward Contract?

Fundamentally, the term “forward contract” represents an agreement between two parties to buy or sell an asset (which can be of any kind) at a future time at a pre-agreed price. The term “prepaid forward contract” is a term used by tax practitioners to characterize a financial instrument pursuant to which one party agrees to purchase one or a combination of financial assets at some point in the future in exchange for payment of the purchase price at the inception of the contract. The contract usually, but not invariably, takes the legal form of a debt instrument, because it is convenient as a legal matter to do so.¹³ The financial assets, which are usually denominated as “referenced assets” or “underlying assets,” may include equity securities, commodities, currencies, debt instruments, options, indices or “baskets”

¹² The market information contained in our submission (including volumes and types of contracts, turnover, and any other similar data) generally is derived from statistical data compiled by the Structured Products Association (“SPA”) (<http://www.structuredproducts.org>) and the New York Stock Exchange (“NYSE”). In addition, some information has been provided through informal surveys of our member firms. We cannot verify the accuracy of all of the information provided by the SPA and NYSE, but it generally is consistent with our members’ knowledge of the market.

¹³ Typically, U.S. corporations have legal documentation in place that provides for the issuance of instruments in the form of debt or stock, and sometimes warrants. Another possible form of legal documentation is the typical form of derivatives documentation — a master agreement developed by the International Swaps and Derivatives Association (“ISDA”) and related ancillary documentation — but it is rare to use such documentation for transactions of this kind, except in highly negotiated one-off transactions, as it is very complex. Since prepaid forward contracts represent a senior claim against the issuer (*i.e.*, they are not stock), the most convenient legal form is that of a debt instrument. As described in more detail below, current law characterizes prepaid forward contracts as non-debt for U.S. federal income tax purposes as a matter of substance. *See, e.g., United States v. Phellis*, 257 U.S. 156, 168 (1921) (recognizing “the importance of regarding matters of substance and disregarding forms in applying the...income tax laws”); *Gregory v. Helvering*, 293 U.S. 465 (1935) (recharacterizing, based on the substance of the arrangement, a transaction designed as a matter of form to qualify as a tax-free reorganization).

consisting of positions in financial assets, and any combination thereof. Prepaid forward contracts include a variety of financial instruments, such as ETNs and other types of structured notes, including commodity-linked and equity-linked notes, as well as variable stock purchase contracts, mandatory exchangeables, mandatory convertibles, and access notes.¹⁴

Prepaid forward contracts may have a variety of financial and economic features. At maturity, a prepaid forward contract may provide for either cash settlement or physical settlement (*i.e.*, for delivery of the referenced assets to the investor). Some prepaid forward contracts pay current coupons, while others do not. If a coupon is paid,

¹⁴ An ETN generally is considered by market participants to consist of a mid- to long-term note actively traded on a major exchange (*e.g.*, the NYSE) during normal trading hours that provides for returns at maturity based upon the performance of one or more financial assets minus applicable fees, and may or may not have periodic coupon payments. Other prepaid forward contracts that are traded on an exchange but are not commonly referred to as ETNs, and which may belong to any of the types of prepaid forwards discussed below, generally do not trade at levels of activity similar to ETNs and therefore are not as liquid. A commodity-linked note generally is a medium-term instrument that may or may not pay a periodic coupon and whose return (paid in periodic coupon payments and/or at maturity) is determined by the performance of a single commodity, a basket of commodities, a commodities index, a strategy, or a combination thereof, and may provide for leveraged returns or returns subject to various thresholds, triggers, buffers, caps, or floors. An equity-linked note generally is an instrument similar to a commodity-linked note, except that the instrument's return is determined by the performance of a single equity security, a basket of equity securities, an equity index, a strategy, or a combination thereof. A variable stock purchase contract generally is a contract that obligates a counterparty to take delivery at maturity of a variable number of shares of common stock of a company unrelated to the taxpayer (or, at the taxpayer's option, receive a cash equivalent), with the number of shares to be delivered typically depending on the performance of the stock so as to minimize or fully eliminate the taxpayer's exposure to the loss on the stock while allowing the taxpayer to retain full participation in gains up to a certain trading value and, in some cases, partial participation in gains above that threshold. A mandatory exchangeable note is similar to a variable stock purchase contract, except that it takes the legal form of debt and generally pays a coupon. A mandatory convertible note generally is an instrument similar to a mandatory exchangeable note, except that the note is convertible into shares of the issuer of the note. An access note generally is a medium-term instrument that provides an investor with the economic returns (including gains, losses, and amounts determined by reference to the dividends) on a foreign stock that is subject to investment restrictions or is otherwise difficult for investors outside the local market to invest in directly. These instruments do not guarantee the return of a purchaser's investment, but may be subject to a variety of thresholds, triggers, or buffers that mitigate an investor's risk of loss.

A similar instrument, but one that has option rather than forward economics, is a reverse convertible note. A reverse convertible generally is a note that provides very high fixed coupon payments in exchange for the investor assuming the risk of loss on one or a group of underlying financial assets, which may be delivered to the investor at maturity. Economically, a reverse convertible note is a put option written by an investor.

it may be higher than — sometimes substantially higher than — or lower than the coupon on a debt instrument of the same issuer. Similarly, prepaid forward contracts may reference a wide variety of assets, ranging from a single common stock to complicated financial formulas that provide leveraged returns and have embedded notional options and/or notional investing in a portfolio of assets that changes over time pursuant to a pre-agreed formula or strategy, and/or notional reinvestment of distributions on underlying assets.¹⁵ Some prepaid forward contracts are traded on exchanges and are highly liquid, while others are traded exclusively in OTC markets and have limited liquidity.¹⁶

As a matter of finance theory, all forward contracts may be viewed as a combination of more basic financial instruments, such as options. Under the fundamental finance concept of “put-call parity,”¹⁷ it is widely recognized that similar economic results can be achieved through many different combinations of financial instruments. Similarly, the cash returns of virtually any asset may be achieved by using derivative instruments.¹⁸ For example, the investment return from investing \$100 in a share of non-dividend-paying common stock for 5 years is the same as the investment return from (i) buying a 5-year call option and writing a 5-year put option with respect to that common stock with same “strike price” and (ii) buying a zero-coupon bond that will

¹⁵ For examples of prepaid forward contracts paying current coupons, see Annex A, Examples 3 and 4; for an example of a prepaid forward contract providing for leveraged returns, see Annex A, Example 1; for examples of capped structures, see Annex A, Examples 1 and 4; for an example of a prepaid forward contract linked to a complicated financial strategy using notional options and reinvestment of premiums received, see Annex A, Example 2.

¹⁶ Generally there is no secondary market for OTC prepaid forward contracts. Issuers, however, generally make a market in such OTC prepaid forward contracts. An investor that wishes to dispose of its position prior to maturity therefore generally will sell it back to the issuer for its then-fair market value. Such purchase transactions are less standardized and more time consuming to complete than a typical trade on a stock exchange.

¹⁷ Stoll, “The Relation Between Put and Call Prices,” 24-5 *J. of Finance* 801-24 (Dec. 1969).

¹⁸ See Joint Committee on Taxation, “Present Law and Analysis Relating to the Tax Treatment of Derivatives,” (JCX-21-08) at 10 (Mar. 4, 2008) (hereinafter, the “JCT Derivatives Report”), available at www.house.gov/jct.

pay an amount equal to the strike price in 5 years. Alternatively, an investor could have the same investment return by investing \$100 in a 5-year prepaid forward contract with respect to that common stock.¹⁹ In view of the fact that our tax system does not tax an investment in stock in the same way as the option/bond combination described above, there is inevitably a divergence in the tax treatment of economically similar financial instruments.

Notwithstanding the variety of the financial and economic features displayed by prepaid forward contracts, a hallmark of a prepaid forward contract is that it is a fundamentally risky investment, just like investment in common stock or other equity instrument. An investor bears a meaningful risk of loss with respect to its upfront investment in such prepaid forward contract. For example, a prepaid forward contract for U.S. tax purposes might require an investor to pay \$100 upfront in exchange for a payout at maturity based on changes in an index based on representative stocks in a particular market. In this case, if the value of the index at the contract's maturity has

¹⁹ The JCT Derivatives Report, *supra* note 18, at 8. To give a few other common examples of equivalencies of different combinations of financial instruments, holding stock and buying a put option on that stock is equivalent to buying a call option and a zero-coupon bond; buying a call option on the stock and selling that stock short is equivalent to buying a put option and borrowing under a zero coupon bond. To quote the JCT Derivatives Report, "Forward contracts, option contracts and swaps on a common underlier thus all are directly related to each other, and to the underlier that they reference. In practice, this close connection means that financial specialists can engineer one such contract from the others, or separate one component of an underlier's returns from the others, and sell those separate components to different taxpayers." *Id.* at 11.

It is common to describe a (non-prepaid) forward price for an underlying asset as a function of the current spot price, any expected cash yield on the asset or cost to carry the asset, and the time value of money. This description is based on the assumption that any investor may undertake a "cash and carry" arbitrage transaction by borrowing (say) \$100 from a bank, buying an asset for \$100, and entering into a forward contract to sell the asset. See the JCT Derivatives Report, *supra* note 18, at 5-6. The JCT Derivatives Report provides the following example of how such arbitrage works: "[I]f one share of stock in Company XYZ costs \$100 today, the one-year interest rate is six percent, and XYZ is expected to pay \$4 per share in dividends over the coming year, [then] the one-year forward price of one share of XYZ stock would be \$102 (\$100 plus 6 percent interest minus \$4 yield). If XYZ stock paid no dividend (or instead XYZ stock was a precious metal or foreign currency), the forward price would be \$106, reflecting simply the time value of money." *Id.* at 7. As this example demonstrates, a conventional forward contract reflects an embedded interest expense. A prepaid forward contract does not; that is, an investor in a prepaid forward contract on the non-dividend-paying XYZ stock described in the example would pay approximately \$100 to make the investment.

increased by 25 percent in relation to the index's value at the contract's inception, the investor would receive \$125; but if the index declined by 25 percent, the investor would not receive any return on its investment in the contract, and would recover only \$75. If the index declined by 75 percent, the investor would receive only \$25 at the contract's maturity.

B. Reasons to Invest in Prepaid Forward Contracts.

Investors in prepaid forward contracts include institutions, mutual funds, tax-exempt investors (e.g., pension funds), life insurance companies, high-net-worth individuals, and other retail investors. The decision to invest in prepaid forward contracts rather than directly in the underlying assets is based on a number of criteria. While tax considerations are, of course, one relevant criterion, they are generally not the principal consideration, as evidenced by the fact that many prepaid forward contracts are taxed under current law in a manner that is less favorable than direct investment in the referenced assets. Investors generally choose prepaid forward contracts because they meet a variety of important financial needs unrelated to tax considerations.

In our experience, investors choose to invest in prepaid forward contracts for some or all of the following reasons: (i) opportunity to gain exposure to a financial asset that otherwise is not available as a practical matter; (ii) opportunity to tailor the risk profile and/or cash flow in a manner that is different from a direct investment; (iii) absence of tracking error with respect to the referenced assets; (iv) lower transaction fees; and (v) convenience, for example, "one-stop shopping." As a result of the virtually unlimited structuring flexibility that is possible with prepaid forward contracts, there has been an explosive growth in the number, volume, and variety of non-principal protected structured notes and other types of investments that are characterized as prepaid forward contracts for U.S. federal income tax purposes.²⁰

²⁰ According to statistics compiled by the SPA, the structured products market (which consists of both principal-protected and non-principal-protected instruments) in the United States grew from \$64

Prepaid forward contracts make complex strategies available to a broad base of investors. Because of the legal form and economic characteristics of these prepaid forward contracts, they are permitted investments for those investors who cannot legally or practically enter directly into options or other derivative transactions on a stand-alone basis or who can do so but are required under applicable investment guidelines to treat them less favorably. For example, most individuals do not invest in commodity futures due to their complicated nature and cash flows.²¹ Mutual funds effectively cannot invest in commodities or commodity futures, except in very limited amounts.²²

In addition, investors in prepaid forward contracts have the potential to benefit from above-market yields or downside protection without the use of OTC options, which might not be available to retail investors because of minimum size requirements to invest in OTC options. Prepaid forward contracts' role in overcoming this constraint has become especially important, because, although institutional investors are important participants in this market, many prepaid forward transactions involve individual investors.

billion in 2006 to \$114 billion in 2007. The dramatic increase in popularity of structured products has been linked to the fact that structured products in many cases offer superior value compared to direct or managed investments. See Benjamin, "Structured products flourish in today's 'choppy market'," *Investment News* (Feb. 4, 2008) (reporting a record-setting 78 percent increase in 2007 sales) available at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080204/REG/544709651>.

²¹ See, e.g., Erb & Harvey, "The Tactical and Strategic Value of Commodity Futures," (January 12, 2006) available at SSRN: <http://ssrn.com/abstract=650923>; Anand & Karmin, "Betting on the Buck," *Wall Street Journal*, B1 (May 12, 2007).

²² Historically, neither direct purchases nor sales of commodities generate regulated investment company qualifying income under section 851(b)(2). See Rev. Rul. 2006-1, 2006-1 C.B. 262 (income from a derivatives contract providing total return exposure on commodity index was not qualifying income under 851(b)(2)). By contrast, mutual funds can invest in commodity-linked notes. See Rev. Rul. 2006-31, 2006-1 C.B. 1133 (clarifying Rev. Rul. 2006-1 and ruling that income from a commodity-linked structured note is qualifying income); PLR 200628001 (July 14, 2006), PLR 200637018 (Sept. 15, 2006), PLR 200647017 (Nov. 24, 2006), PLR 200701020 (Jan. 5, 2007), PLR 200745021 (Nov. 9, 2007); PLR 200822010 (Feb. 12, 2008). Structured notes thus satisfy a market demand that would not otherwise be met.

Investors enter into most prepaid forward contracts in order to acquire an investment that permits them to take a finely tailored financial position that often cannot be obtained through existing standardized investments or because of cost barriers. In some instances, investors simply cannot create such positions through a direct investment, because, for example, listed options may not be available at the exact strike prices desired by the investor. Prepaid forward contracts give investors convenient and cost-efficient access to sophisticated financial strategies and enable them easily to “express their views” regarding future market movements by taking direct financial positions with respect to customized combinations of referenced financial assets and cash flows.

For index investments (e.g., an investment in the Dogs of the Dow index or the Dow Jones-AIG Commodity index), prepaid forward contracts allow investors to achieve zero tracking errors, with the only deviation from the index performance attributable to the embedded fees. With prepaid forward contracts, any tracking error risk is borne by the issuer as its hedging risk, rather than by the investor. By comparison, investments in index-linked exchange-traded funds are expected to produce some tracking errors, which vary in magnitude depending on the fund and may be significant.²³

²³ Annualized tracking error is expressed as the annualized standard deviation of the difference between the daily returns of a portfolio and its benchmark. It quantifies the degree to which the historic performance of a portfolio differs from that of a benchmark or index used for comparison in using an indexing or any other benchmarking strategy. All else being equal, tracking error tends to be smaller over shorter measuring periods and larger over longer ones. Tracking error also may vary widely depending on the type of index, with broader indices or strategies generally producing lower tracking errors.

Articles by academics and financial publications suggest that even small tracking errors are considered material in evaluating how well a strategy succeeds in replicating the performance of an index. See, e.g., “Index Funds Aren’t All Equal,” *Business Week* (Apr. 19, 2004) (describing a 38 basis point (0.38 percent) tracking error between the average S&P 500 fund and the S&P 500 index as “startling,” and quoting one expert as saying a 5 basis point (0.05 percent) tracking error is what would be expected, prior to fund expenses); Blume & Edelen, “On Replicating the S&P 500 Index” (Rodney L. White Center for Financial Research, The Wharton School, University of Pennsylvania, Apr. 2002) (largest manager of index funds reports average annual tracking error of 2.7 basis points (0.027 percent), maximum tracking error of 7 basis points (0.07 percent), and minimum tracking error of –1 basis point (–0.01 percent) for its S&P 500 index fund over a 9-year period). Other sources report somewhat wider

Another advantage of prepaid forward contracts is that the transaction costs of entering into a prepaid forward contract that provides returns based on the performance of a complex formula are significantly lower than the costs an investor would incur if it attempted to enter into a combination of financial instruments that would give rise to similar returns. That is especially true if the formula payout is determined by reference to many different types of assets and employs leverage. For example, based on an informal survey of our members, while fees embedded in prepaid forward contracts vary widely, on average they represent only a fraction of the expected transaction costs of maintaining a direct account implementing a strategy or expected fees charged by a mutual fund pursuing that strategy.

Finally, prepaid forward contracts provide “one-stop shopping” for investors, allowing an investor to make a single investment in order to obtain exposure to several asset classes they could not otherwise access. Investors generally prefer the simplicity of investing in a single security, rather than in multiple assets and/or contracts in order to create customized portfolios. By comparison, investors might need to invest in several mutual funds with different risk profiles, or to buy small positions in many stocks and enter into related options, in order to create a customized equities exposure. It is also easier and more cost-efficient for an investor to invest pursuant to a single standardized offering document, rather than pursuant to an individually negotiated contract documented under ISDA documentation and confirmations.

discrepancies. According to Bloomberg LLP, tracking error may reach as high as 236 basis points (2.36 percent) between an S&P 500 ETF and the S&P 500 index. For exchange traded funds providing access to specialized indices, tracking errors may reach as high as 478 basis points (4.78 percent) before taking into account any fees or expenses. See “The Trouble With ETFs: Part II,” *Business Week* (Jan. 29, 2008) (citing a Morgan Stanley Research study which identified six ETFs with 2007 tracking errors greater than 300 basis points (3 percent)), *available at* http://www.businessweek.com/investing/insights/blog/archives/2008/01/the_trouble_wit.html.

C. Development of Prepaid Forward Contracts.

Prepaid forward contracts are not a new financial development. Complex instruments with returns linked to the performance of equities and other risky assets have been in existence for more than 20 years. The first such contracts were fully principal-protected notes that provided a contingent return based on the performance of the S&P 500 index at maturity of the note. These instruments were issued first in the private placement market, and then in the registered (public) market.²⁴

In 1993, the first publicly-traded *non*-principal protected prepaid forward contract was issued.²⁵ This instrument paid a periodic fixed coupon, and provided that at maturity an investor would receive a variable number of shares of the referenced stock, depending on the stock's value at maturity. The investor could make money or lose money depending on whether the referenced stock rose or fell in value. Under the share delivery formula the investor gave up some of the opportunity to profit from a rise in value, in exchange for the right to receive coupons. Economically, therefore, the instrument was equivalent to buying the underlying stock and writing a "call spread" (*i.e.*, a combination of call options with different strike prices), and the coupons economically represented option premium.

Option premium is not taxable until the exercise or other disposition of the option. The tax treatment of this instrument, however, was far less favorable to investors, because the coupons were treated as current ordinary income for U.S. federal income tax purposes. Notwithstanding this unfavorable tax treatment,

²⁴ For a discussion of these instruments, see Chen & Spears, "Pricing the SPINs," *Financial Management*, Financial Management Association, Summer 1990, at 36-47, and Finnerty, "Interpreting SIGNS — stock index growth notes — Security Design Special Issue," *Financial Management*, Financial Management Association, Summer 1993, at 34-47.

²⁵ American Express, 21,000,000 DECSSM (Debt Exchangeable for Common StockSM) 6 1/4% Exchangeable Notes due October 15, 1996. Investment banks use a variety of service marks for instruments of this kind.

instruments of this kind have become a standard part of the capital markets, because of the economic advantages they offer to both issuers and investors.²⁶

Originally, prepaid forward contracts of this kind frequently were employed by issuers in order to hedge, or provide for future disposition of, their own stockholdings in unrelated corporations. Over time, as discussed in Section II.B above, prepaid forward contracts have evolved into a means for derivatives dealers to provide their customers with access to highly structured, customized investments in financial assets.

The most recent development in the market has been prepaid forward contracts that are actively traded on a stock exchange, or ETNs. Despite coming into the spotlight as a perceived recent financial innovation, ETNs represent only a subset of prepaid forward contracts that are listed and traded on an exchange.²⁷ In general, prepaid forward contracts have been listed and traded on exchanges at different levels of activity since the early 1990s. The main innovative feature of ETNs is that they are traded on the NYSE Arca²⁸ and the American Stock Exchange in a manner similar to stock and therefore are very liquid and have a readily ascertainable market value.²⁹

²⁶ These points are discussed in more detail in Farber, "Equity, Debt, NOT—The Tax Treatment of Non-Debt Open Transactions," 797 *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 621, Practising Law Institute (Oct.-Nov. 2006) (hereinafter, "Farber"). See also the JCT Derivatives Report, *supra* note 18, at 7; Brown, "Separation Anxiety," *Tax Forum*, No. 582 (2005), at 10; Kleinbard, Nijenhuis, & McRae, "Everything I Know About New Financial Products I Learned from DECS," 791 *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 741, Practising Law Institute (Oct.-Nov. 2007) (hereinafter, "Kleinbard, Nijenhuis & McRae"); Rosenthal & Dyor, "Prepaid Forward Contracts and Equity Collars: Tax Traps and Opportunities," *J. Tax'n Fin. Prod.*, Winter 2001, at 35.

²⁷ While the available data does not clearly distinguish between principal-protected and non-principal protected structured notes, there may be several hundred prepaid forward contracts listed and traded at some level of activity on an exchange that are not considered ETNs.

²⁸ NYSE Arca is a fully electronic stock exchange that has less stringent eligibility requirements than NYSE. More information about NYSE Arca is available at <http://www.nyse.com/about/listed/1150366630075.html>.

²⁹ As discussed in *supra* note 6, in order to be considered an ETN for purposes of trading on an exchange, a prepaid forward contract must be redeemable by the issuer at least on a weekly basis.

ETNs are denominated in relatively small face amounts (e.g., \$50) and so can easily be bought and sold by retail investors. The first two ETNs were issued in June 2006.³⁰

These ETNs provide the holders with exposure to the returns potentially available through an unleveraged investment in a standard commodity index widely used as a benchmark for commodity risk (the AIG Commodity Index Total ReturnSM and the S&P GSCITM) and associated margin.³¹ These ETNs have become widely used by both institutional and retail investors as a straightforward and convenient way of investing in the booming commodities market. As a result, retail investors, along with the more traditional institutional investor base, have been in a position to benefit from the rise in the prices of commodities. On the other hand, because ETNs do not provide any protection of the holder's investment, if the commodities markets cool down or start declining, investors stand to lose significant amounts.³²

Since then, many leading banks and investment banks have issued ETNs. As the market in ETNs has developed, variations have been created in response to perceived investor demand, much as was the case for OTC prepaid forward contracts. For example, more recent ETNs have provided exposure to emerging markets equity

³⁰ See Barclays Dow Jones – AIG Commodity Index Total ReturnSM ETN, *supra* note 8, and Barclays Bank PLC, Prospectus \$750,000,000 iPath® S&P GSCITM Total Return Index ETN linked to the S&P GSCITM Total Return Index due June 2036, *available at* <http://www.ipathetn.com/pdf/gsp-prospectus.pdf>. For a discussion of ETNs, see Spence, “ETF Boom Expands With Exchange-Traded Notes,” *Wall Street Journal* (Aug. 5, 2006); Sykora, “And Now, meet ETNs” *Barrons Online*, *available at* <http://online.barrons.com/article/SB115049878651382917.html?mod=googlebarrons>.

³¹ More specifically, the ETN's performance is determined by reference to a specified set of commodity futures contracts that make up the commodity index. Unlike actual futures contracts, which are highly leveraged and risky instruments that most investors either cannot or choose not to invest in, the ETN is unleveraged, meaning that the investor cannot lose more than its original investment and that the formula for the return on ETN includes a component determined by reference to a rate of interest on that investment, treating that hypothetical interest as reinvested in the index on an on-going basis. The concept of notional reinvestment is further discussed in Section III.B, below.

³² For example, as discussed in note 8, *supra*, the Barclays Dow Jones – AIG Commodity Index Total ReturnSM ETN has varied in price significantly since issuance, including by falling by about 10 percent, more than once over the past several months. This level of volatility demonstrates that even for ETNs that include an interest-like component in their payout formula, investors bear a genuine risk of loss with respect to both their original investment and any returns that are notionally reinvested in the underlying assets.

indices,³³ master limited partnerships,³⁴ and customized equity exposures.³⁵ In addition, as with OTC prepaid forward contracts, there are ETNs that provide for payment at maturity based on complicated formulas or combinations of underlying assets (such as a buy-write index or commodities long and short position arbitrage).³⁶

In general, the types of prepaid forward contracts and the particular risk profiles offered in the markets at any particular time depend primarily on the overall performance of the financial markets and the availability and performance of alternative investments. The majority of prepaid forward contracts for U.S. tax purposes currently are issued in the OTC market, which means that they are not traded on a securities exchange and therefore have limited liquidity. According to a survey of our members, although the outstanding amount of OTC transactions is impossible to quantify precisely, it is estimated very roughly to exceed \$25 billion, as compared to approximately \$6 billion of outstanding amount of ETNs and approximately \$14 billion of outstanding amount of other exchange-traded contracts.

Most OTC transactions have relatively short maturities ranging from a few months to a few years. By comparison, ETNs issued to date generally have longer stated maturities, in some cases up to 30 years, although, as discussed below,

³³ See, e.g., Barclays Bank PLC, Prospectus, \$1,000,000,000 iPath® MSCI India IndexSM ETN, due December 2036, available at <http://www.ipathetn.com/pdf/inp-prospectus.pdf>.

³⁴ See, e.g., Bear Stearns Companies, Inc., Prospectus, \$75,039,438 BearLinxSM Alerian MLP Select Index ETN, due July 2027, available at http://www.bearstearns.com/includes/pdfs/institutions/equities/alerial_etn_prospectus.pdf (hereinafter the “BearLinxSM Alerian MLP Select Index ETN”).

³⁵ See, e.g., Lehman Brothers Holdings, Inc., Prospectus, \$250,000,000 Opta Exchange-Traded Notes due February 25, 2038 Linked to the S&P Listed Private Equity Index® Net Return (U.S. dollar), available at <http://www.optaetn.com/products/products.asp?symbol=PPE>.

³⁶ See, e.g., Barclays Bank PLC, Prospectus, \$250,000,000 iPath® CBOE S&P 500 BuyWrite IndexSM ETN, available at http://www.ipathetn.com/pdf/BWV_prospectus.pdf; Deutsche Bank, Prospectus, \$500,000,000 DB Gold Double Short Exchange Traded Notes due February 15, 2038, available at http://www.dbfunds.db.com/notes/Pdfs/DB_Notes_Gold_Offerings.pdf (hereinafter “Deutsche Bank Gold Double Short ETNs”). See also Anand & Karmin, *supra* note 21 (discussing currency linked ETNs: “The investment strategies can get complex. Some use derivative investments in their portfolios and may engage in short-selling...Others try to magnify bets by investing borrowed money.”).

investors on average buy and sell ETNs very frequently so that the actual maturity of the ETN is relatively insignificant for those investors. In addition, many OTC transactions (and at least two ETNs³⁷) currently pay out all or a significant portion of their expected returns in the form of current coupons.³⁸ Although impossible to quantify precisely, we estimate that a significant number of prepaid forward contracts currently in the market pay coupons. These coupons may be significantly higher than a conventional time value of money return.

Popular types of prepaid forward contracts include buffer notes, which generally give the investor exposure to the underlying assets with moderate protection against downside risk; levered notes which give the investor a leveraged upside return in comparison to an investment in the underlying asset; and tracker notes that give the investor a capped upside return.³⁹

As of the end of May 2008, there are approximately 69 ETNs outstanding with a total market capitalization of approximately \$6.5 billion. Of these, the single largest ETN, linked to the DJ-AIG Commodity Total Return Index, represents about \$3.5 billion in face amount and about 55 percent of the outstanding amount in the entire ETN market.⁴⁰ The most popular ETNs are linked to commodities. ETNs linked to emerging markets are the next most popular and are the most actively traded.

³⁷ See, e.g., The Goldman Sachs Group, Inc., Prospectus, \$50,000,000 Claymore CEF Index Linked GS ConnectSM ETN Index-Linked Notes Due 2037, *available at* [http://www.secinfo.com/\\$/SEC/Filing.asp?404;http://www.secinfo.com/dsvr4.ug2s.htm](http://www.secinfo.com/$/SEC/Filing.asp?404;http://www.secinfo.com/dsvr4.ug2s.htm); the BearLinxSM Alerian MLP Select Index ETN, *supra* note 34.

³⁸ Reverse convertible notes (which generally are not treated as prepaid forward contracts by issuers) provide a current coupon well in excess of the yields paid on fixed income products (e.g., commercial paper or fixed-rate notes) in exchange for investors taking on downside risk on the underlying (generally, a single stock). Reverse convertible notes generally have short terms, from a few months to a little over one year. See Annex A, Example 5.

³⁹ For an illustration of these features, see Annex A, Example 1.

⁴⁰ See *supra* note 30. The market is currently highly concentrated; the largest 10 ETNs have an aggregate market capitalization of over \$5.5 billion. Of those 10, 9 are linked to commodity indices, and 1 to an emerging market index.

According to the NYSE Euronext, generally ETNs are more actively traded on average than even the most actively traded stocks. For example, IBM and GE, two of the most actively traded stocks, have a ratio of average daily trading volume to shares outstanding (or “daily turnover”) of approximately 0.7 percent and 0.6 percent, representing an average holding period of 142 days and 167 days, respectively. By contrast, ETNs as a group have a daily turnover of approximately 1.8 percent, representing an average holding period of 56 days. The ETN with the highest daily turnover is the iPath® India (INP) with a daily turnover of approximately 3.9 percent, representing an average holding period of 26 days.⁴¹ The average daily trading volume for ETNs in May 2008 was approximately \$104 million per day.

III. CURRENT TAX LAW ANALYSIS OF PREPAID FORWARD CONTRACTS.

A. Characterization of Prepaid Forward Contracts as Non-Debt Derivative Financial Instruments.

As an initial matter, although a prepaid forward contract economically may be viewed as a combination of options and/or other financial instruments, for tax purposes, it generally is analyzed as a single financial instrument. As discussed in more detail in Section V.B.2, below, with very limited exceptions, current tax law generally does not bifurcate or deconstruct financial instruments into their constituent parts. Instead, a financial instrument generally is assigned a tax classification and taxed under a corresponding single set of tax rules. As a result, the tax characterization and treatment of a financial instrument generally involves an “all or nothing” determination, even though a particular financial instrument may have economic features that do not all fit neatly into the same tax category. For example, the contract discussed in Annex A, Example 1, may be viewed as the purchase of 225 stocks and the purchase and sale of call options with respect to those stocks; or instead as

⁴¹ For prospectus, see *supra* note 33.

The turnover numbers above are averages; some holders of ETNs necessarily have shorter holding periods, while others have longer holding periods.

consisting of a different package of options that provide the leveraged payout profile; or, under the “buffer” alternatives, as an options package plus debt instrument that guarantees a return of at least 10 percent of the holder’s investment. Nevertheless, under current law, the entire contract generally is taxed as a single instrument, under a single set of rules.

Tax law draws a fundamental distinction between financial instruments that constitute debt and those that do not. Investors in debt generally are required to accrue expected returns on their debt investment currently, even if no cash is received until the instrument’s maturity, because debt instruments guarantee an unconditional repayment of all or virtually all of the investors’ original investment and generally provide for a time-value-of-money return. By comparison, non-debt instruments (such as stock, options, forward contracts, and NPCs) generally are treated as “open transactions,” which are not taxed on “phantom income.” The contingent returns on such instruments are taxed at the time fixed or received, because investors generally assume a risk of loss of their original investment in the hope of receiving an unpredictable (but potentially greater) return. As a result of this distinction under current law, the first step in determining the tax treatment of a prepaid forward contract is to classify the contract as either a debt or non-debt instrument.

There are currently no statutory or regulatory provisions that specifically address the characterization of prepaid forward contracts as debt or non-debt financial instruments. The numerous and well-known authorities attempting to define which economic and legal terms will cause an instrument to constitute indebtedness for U.S. federal income tax purposes are almost exclusively concerned with the question of whether an instrument issued as part of a corporate financing should be treated as debt or equity of the financed entity.⁴² By contrast, prepaid forward contracts generally are

⁴² See, e.g., *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968) (cataloguing sixteen specific criteria by which to judge the true nature of an investment which is in form a debt instrument: (1)

not issued for the purpose of raising corporate funds, but rather as a means for a derivatives dealer to provide customers with investment returns referenced to other financial assets. In addition, prepaid forward contracts could not credibly be characterized as an equity interest in the issuing entity. As a result, most traditional analysis factors viewed as important in the traditional debt/equity case law and administrative guidance have proved largely irrelevant in addressing the proper characterization of prepaid forward contracts.⁴³

Current debt/equity law, however, provides extensive support for the conclusion that *the key factor* for purposes of characterizing transactions as debt rather than prepaid forward contracts is whether the contract represents an obligation to pay a “sum certain” on demand or at a fixed maturity date in the reasonably foreseeable future.⁴⁴ In particular, the leading decisions in the debt/equity line of cases have held that the promise to pay a “sum certain” is an essential characteristic of debt.⁴⁵ Various

the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the “thinness” of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation). See *also* section 385(b) (listing debt-equity factors that may be reflected in future regulations as (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question).

⁴³ See Farber, *supra* note 26, at 625-31.

⁴⁴ See *generally* Plumb, “The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal,” 26 *Tax L. Rev.* 369 (1971); Kleinbard, Nijenhuis & McRae, *supra* note 26; Farber, *supra* note 26; Rubinger, “Taxation of Variable Prepaid Forward Contracts Uncertain (Once Again) in Light of Recent TAM,” 104 *J. Tax’n* 296 (2006); Levy, “Towards Equal Tax Treatment of Economically Equivalent Financial Instruments: Proposals for Taxing Prepaid Forward Contracts, Equity Swaps and Certain Contingent Debt Instruments,” 3 *Fla. Tax Rev.* 471 (1997).

⁴⁵ See *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957) (the leading case establishing the current debt-equity jurisprudence, stating that “classic debt is an unqualified obligation to pay a sum certain”); *Wood Preserving Corp. v. United States*, 347 F.2d 117, 119 (4th Cir. 1965) (listing “an obligation

legislative and regulatory authorities also consistently have identified the promise to pay a “sum certain” as a crucial factor in determining whether an instrument constitutes debt.⁴⁶ Under these authorities, an instrument is characterized as debt only if the instrument unconditionally promises investors a return of all or virtually all of their original investment. Thus, for example, the contract described in Annex A, Example 1, would not be characterized as debt, because an investor is not promised the “sum certain” return of its original investment in the contract. The investor is only promised an amount contingent on the performance of the Nikkei 225 index and, therefore, may lose a substantial portion of its investment in the contract if the Nikkei 225 index decreases in value.

Although no tax law authority treats as debt any instrument that by its terms does not unconditionally guarantee the return of virtually all of the holder’s investment, the overarching importance of economic substance in U.S. federal tax law has led practitioners to be concerned that if the risk of loss on an instrument is *de minimis*, lack of formal entitlements alone might not be sufficient to support non-debt

to repay in *all events*” as one of two “*indispensable* indicia of a creditor relationship”) (emphasis added); see also *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968) (listing “a contingency on the obligation to repay” as one of the many criteria by which to judge the nature of an investment which is in form debt); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987) (debt-equity determination “depends on whether the objective facts establish an intention to create an *unconditional* obligation to repay the advances”) (emphasis added).

⁴⁶ See section 385(b)(1) (listing an “unconditional promise to pay on demand or on a specified date a sum certain” as the first of the five factors that Treasury regulations may use in drawing the line between debt and equity); Notice 94-47, 1994-1 C.B. 357 (addressing the characterization of “hybrid” debt/equity instruments and listing the unconditional right to repayment of principal as the first in a list of factors). See also Rev. Rul. 83-98, 1983-2 C.B. 40 (twenty-year adjustable convertible rate notes were equity because of the “very high probability” that such notes would be converted into a fixed number of the issuer’s shares, and thus did not represent a “promise to pay a sum certain”); Rev. Rul. 85-119, 1985-2 C.B. 60 (convertible notes were debt because, among other reasons, the investors were unconditionally entitled to be repaid the principal invested as a “sum certain,” although such repayment in form was expected to be made in the stock of the issuer, which then would be deemed sold to raise the cash due to the holders); Rev. Rul. 90-27, 1990-1 C.B. 51 (dutch auction rate preferred stock treated as equity of the issuer, rather than debt, because it conferred “no right to receive a sum certain” notwithstanding the fact that stockholders were largely insulated from the actual risk of loss due to the auction procedures); Rev. Rul. 2003-97, 2003-2 C.B. 380 (applying the “sum certain” factor to the debt component of an investment unit).

characterization.⁴⁷ Accordingly, dealers generally use a variety of factors that make sense in light of the relevant facts to evaluate the investors' risk of loss as a practical economic matter. Each dealer generally uses several criteria that reflect the legal judgment of both the dealer's tax department and the outside legal advisors that serve as tax counsel for the instrument's offering. Such criteria generally are selected to achieve a degree of confidence in treating the transactions as non-debt financial instruments for tax purposes based on both legal and practical considerations.⁴⁸

While each dealer's set of criteria is unique, the evaluation generally considers several factors, which may be divided into two broad categories. The first category aims to assess the holders' risk of loss of their investment in the contracts and may include one or more of the following: (i) whether the investor is guaranteed to receive any amount of its investment back (including by virtue of receiving any fixed-rate periodic payments), and if so, how much; (ii) whether the underlying assets are inherently risky assets; (iii) what are the probabilities of *any* loss of investment in the contract based on the implied volatility⁴⁹ of the underlying assets; (iv) what are the

⁴⁷ We note in this regard that the Treasury regulations that provide rules for the treatment of CPDIs and variable rate debt instruments expressly cover instruments that allow for contingent recovery of a portion of principal. Specifically, the regulations provide that a long-term instrument that unconditionally guarantees recovery of only approximately 87 percent of principal may be characterized as variable-rate debt, and also treat an equity-linked instrument that unconditionally guarantees recovery of 97.5 percent of principal at maturity as debt. See Treasury regulation section 1.1275-5(a)(2); Treasury regulation section 1.1275-4(b)(7)(vi), *Ex. (1)*; see also Treasury regulation section 1.1275-4(b)(4)(vi), *Ex. (1)* (equity-linked instrument that unconditionally guarantees recovery of only 65 percent of principal at maturity but also provides for fixed coupons exceeding 35 percent of principal in total treated as debt). The regulations state repeatedly, however, that no inference is intended as to the characterization as debt or otherwise of instruments in examples.

⁴⁸ We note that treating prepaid forward contracts as non-debt derivative financial instruments can have disadvantages to issuers. For example, while the issuer of a debt instrument can make an integration or hedging election with respect to a related hedge, the issuer of a non-debt instrument generally cannot.

⁴⁹ Volatility is a statistical measure of the tendency of a market price or yield to vary over time. Volatility is one of the most important elements in evaluating an option, because it is usually the only valuation variable not known with certainty in advance. Implied volatility is the value of the volatility variable that buyers and sellers appear to accept when the market price of an option is determined. Implied volatility is calculated by using the market price of an option as the fair value in an option model and calculating (by iteration) the volatility level consistent with that option price. Gastineau & Kritzman,

probabilities of a *sizable* loss of the investment; (v) whether the investor would have experienced any loss in the past based on the historic performance of the referenced assets; and (vi) how the probabilities of loss on the contract compare with the probabilities of loss on a hypothetical direct investment in the underlying assets. The second category includes other factors that make an instrument more or less debt-like, such as (i) whether the contract pays any current coupons and if so, what are the relative amounts paid and how are these amounts determined;⁵⁰ (ii) what is the term of the contract; (iii) whether the contract is physically settled or cash settled; and (iv) whether the investor's maximum potential return is commensurate with the normal "time-value-of-money" return (as adjusted for the issuer's credit risk) that one would expect as compensation for the temporary use of funds.⁵¹

Under these criteria, for example, there would be a high degree of confidence that the contract described in Annex A, Example 1, would be treated as a non-debt instrument on the grounds that investors assume unlimited exposure to loss based on the performance of the Nikkei 225 index. If the contract also had a buffer feature, as described in the alternative, the issuer would undertake a more extensive analysis of the kind described above in order to determine the level of confidence on the non-debt tax treatment.

Dictionary of Financial Risk Management 165, 328 (Frank J. Fabozzi Associates 1999). For a discussion of the use of implied volatility in financial analysis, see Fabozzi, *The Handbook of Fixed Income Securities* at 1246-47 (7th Ed., 2005).

⁵⁰ See, e.g., Rev. Rul. 83-98, 1983-2 C.B. 40 (interest coupons linked to the amount of dividends paid on stock underlying adjustable rate convertible notes was an ancillary factor supporting non-debt characterization).

⁵¹ As discussed in Section IV.B.2, below, the current tax system treats some instruments providing for contingent returns as debt, assuming that the holder is guaranteed the return of all or virtually all of its investment. Thus, although the possibility of equity-like returns does provide additional evidence that a certain contract fits within the non-debt risk/reward investment profile, alone it is not sufficient to support the non-debt tax treatment. See, e.g., Farber, *supra* note 26, at 640-62.

B. Taxation of Investors in Prepaid Forward Contracts Under Current Law.

1. In general. As discussed above, under current law, prepaid forward contracts with respect to equities and commodities⁵² generally are characterized as non-debt instruments and taxed under the “wait-and-see” method of tax accounting. While the taxation of investors in prepaid forward contracts has not been addressed in a comprehensive manner by either Congress or the Treasury and the IRS, the limited rules and guidance that currently exist confirm that open transaction treatment generally is appropriate for at least some purposes.⁵³ Under this method, the purchase of a prepaid forward contract generally has no immediate income tax consequences. The prepaid forward contract is treated as an open transaction until the contract is settled.⁵⁴ Accordingly, investors are not required to recognize any current income with respect to any contingent payouts until such payouts are received or become fixed. The open transaction treatment is considered fair to investors, because it does not require

⁵² Certain transactions with respect to foreign currencies, including derivatives and certain transactions in form resembling prepaid forward contracts, are taxed under a completely different set of rules than are other derivatives. Section 988; Rev. Rul. 2008-1, 2008-2 I.R.B. 248 (Dec. 7, 2007) (holding that a certain type of a currency-linked derivative is treated as a foreign-currency denominated debt instrument). In addition, certain exchange-traded derivatives are subject to special rules under section 1256. These rules are discussed in more detail in Section IV.B.3, below. Finally, we do not discuss credit-linked notes in this submission, because they are financial instruments that are substantively very different from prepaid forward contracts.

⁵³ See, e.g., Section 1259(a), (d)(1) (entering into a forward contract results in a constructive sale of an offsetting financial position only if the “forward contract” provides for the delivery of a “substantially fixed amount of property (including cash) for a substantially fixed price”); Rev. Rul. 2003-7, 2003-1 C.B. 363 (entering into a variable prepaid forward contract does not result in an actual or constructive sale of the underlying stock); *but see* Rev. Rul. 2008-1, 2008-2 I.R.B. 248 (Dec. 7, 2007) (a foreign-currency linked transaction in form resembling a prepaid forward contract taxed as a foreign-currency denominated debt instrument based on a unique set of facts falling within the scope of section 988).

⁵⁴ See, e.g., *Virginia Iron Coal & Coke Co.*, 37 B.T.A. 195 (1938), *aff’d*, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1938); Rev. Rul. 58-234, 1958-1 C.B. 279, 283. Prepaid forward contracts that are traded on an exchange present additional issues under current law, such as whether section 1256 applies. See, e.g., Morgan Stanley, Prospectus, \$100,000,000 Market Vectors–Chinese Renminbi/USD ETNs due March 31, 2020, *available at* http://www.marketvectorsetns.com/index_ETN.cfm?cat=4111&cGroup=ETN&ShowIt=Prospectus&LN=1-07#, (hereinafter the “Morgan Stanley Market Vectors–Chinese Renminbi/USD ETNs”) (providing in the tax disclosure that the ETN should be treated as a “foreign currency contract” subject to section 1256).

recognition of phantom income and because it strikes a good balance with the taxation of the underlying assets. In addition, it is simple, clear, and easily administrable.

If a prepaid forward contract is settled by delivery of the property underlying the contract, the taxpayer receiving the property generally is treated as purchasing such property and does not recognize either gain or loss, but takes a tax basis in the received property equal to the upfront investment in the prepaid forward contract. If a forward contract is cash-settled, the recipient of the payment recognizes at that time gain or loss equal to the difference between the amount received and its upfront investment in the contract. This gain or loss is capital if the underlying property is capital in nature.⁵⁵ If a forward contract is sold, gain or loss is recognized, and the character of the gain or loss is capital if the forward contract is a capital asset in the hands of the selling taxpayer.⁵⁶

Some prepaid forward contracts reference “dynamic” underlying assets, which means that such prepaid forward contracts reference a notional investment in a group or basket of assets the constituents of which are periodically “rebalanced” in accordance with the predetermined rules of a synthetic investment strategy. Generally, if changes in the underlying assets occur pursuant to a predetermined formula, such

⁵⁵ Section 1234A.

⁵⁶ To take a simplified example, an investor purchases for \$100 a 3-year prepaid forward contract with respect to one share of non-dividend paying stock of Company C, which at the contract’s inception is worth \$100. Pursuant to the contract, the holder will receive no payments during the term of the contract and will receive one share of Company C stock (or the cash equivalent, at the investor’s choice) at maturity. The investor generally would have the following tax consequences under current law. If the investor receives stock at maturity, the investor will not recognize any gain or loss, regardless of whether the stock appreciated, declined in value, or stayed the same, and the tax basis in that share will equal the purchase price paid for the prepaid forward contract (\$100). This treatment is comparable to the consequences of investing directly in the share on day 1, except that the investor’s holding period for the stock would begin only when it acquires the share at maturity of the contract. If the investor chooses to receive cash at maturity, the investor will be required to recognize long-term capital gain or loss equal to the difference between the amount of cash received and its tax basis in the prepaid forward contract (*i.e.*, \$100). For example, if the stock appreciated and the investor receives \$150 (the stock’s cash value) at maturity, the investor will recognize \$50 of long-term capital gain. If the stock declined in value and the investor receives \$50, the investor will recognize \$50 of long-term capital loss.

changes are not treated as “realization” events with respect to the instrument as a whole (*i.e.*, they do not give rise to a sale of the “old” contract and simultaneous deemed acquisition of a “new” contract or components thereof). This tax treatment reflects the economic substance of the transaction, which is that the investor acquires an indivisible package of risks by investing in the contract. In addition, as a more technical matter, this tax treatment is premised on the general rule that when the return to the investor is based on an objective financial formula agreed to in advance, there has been no fundamental change in the investment made.⁵⁷ It is also considered appropriate and consistent with the real-world differences between actually investing in the underlying assets and investing in the prepaid forward contract, since the investor cannot “cherry pick,” shed, or modify any of the particular risks.⁵⁸ Accordingly, the holder of the instrument is viewed as investing in a single financial contract, rather than a simple aggregate of assets.

In addition, some prepaid forward contracts may provide for notional reinvestment of dividends, interest, or other returns on the underlying assets. The “wait-and-see” method also applies to these contracts, because all of the notionally reinvested amounts also are subject to the performance of the referenced assets and

⁵⁷ See Rev. Rul. 90-109, 1990-2 C.B. 191 (exercise of an option under the original contract treated as an exchange if “there is a sufficiently fundamental or material change that the substance of the original contract is altered”); *cf.* Treasury regulation section 1.1001-3(c) (alteration of legal right or obligation of debt instrument by operation of its terms is not “modification,” except where it gives rise to certain fundamental changes or is negotiated at the time the change is made). See *generally* Peaslee, “Modifications of Nondebt Financial Instruments as Deemed Exchanges,” 95 *Tax Notes* 727 (Apr. 29, 2002).

⁵⁸ This treatment is consistent with the well-established treatment of swaps under Treasury regulation section 1.446-3, under which changes in the composition of an underlying index (*e.g.*, the S&P 500) during the swap’s term do not cause tax realization events with respect to the swap. In fact, stocks are frequently replaced in certain well-known broad-based indices such as the Russell 2000. See, *e.g.*, Hulber, “Conventional Wisdom, Foiled Again,” *New York Times*, at BU5 (June 1, 2008) (a study found that some 457 companies, on average, were replaced each year from 1979 to 2004 in the Russell 2000 index; findings also are relevant for the S&P 500 index). By contrast, if an investor attempted to replicate the performance of the S&P 500 index by creating a customized portfolio consisting of 500 stocks, the sales of shares that would be necessary in order to rebalance the portfolio would result in taxable events for the investor.

the investor may receive none of such “phantom income” or “paper gains” at the maturity of the instrument. For example, Annex A, Example 2, describes a contract that is linked to a financial strategy (the CBOE Buy-Write Strategy) equivalent to owning the shares in the S&P 500 index, the notional writing of call options on the index, and the notional reinvestment of the option premiums and any dividends deemed received in additional S&P500 index shares. Any of the returns that are notionally reinvested in the additional shares remain subject to the risk of loss. By contrast, if these returns were not notionally reinvested, but instead set aside for investors, accumulated, and unconditionally paid at maturity, then investors would be entitled to receive such amounts at the contract’s maturity regardless of the performance of the CBOE Buy-Write Strategy and likely would not be subject to a material risk of loss with respect to those amounts. In addition, in contrast to automatic dividend reinvestment plans, once an investor acquires a prepaid forward contract, at no time during the contract’s term does the investor have any right to choose whether to withdraw any notional dividends in cash or to reinvest them in the referenced assets.⁵⁹

2. Treatment of periodic payments. There is no authoritative guidance that addresses the tax characterization and treatment of periodic payments paid under the terms of prepaid forward contracts and their treatment, therefore, is unclear. As an economic matter, periodic payments may represent different cash flows, including current returns on the underlying assets (e.g., dividends taken into account in computing a total-return equity index) and option premiums paid for various options embedded in the prepaid forward contracts, and may be intended to compensate the holders for taking on some specific risks.

⁵⁹ Although some ETNs permit some investors to redeem their securities in an in-kind distribution, such investors cannot selectively cash out the dividends or other returns while maintaining the investment in the security, but rather must liquidate the whole security, which is essentially the same as selling it.

For example, under the contract discussed in Annex A, Example 4, the holder is entitled to receive annual fixed coupons of 8 percent, in part, in exchange for giving up the potential future appreciation on the underlying stock in excess of \$60 per share. As an economic matter, entering into the contract is equivalent to purchasing the underlying stock at \$50 per share and writing a call option on the stock with a strike price of \$60. Under this economic characterization, it is clear that a part of the annual fixed coupon represents a net option premium received. If the coupon were characterized for tax purposes according to its economic substance, then a part of it would not be included in the holder's income until the contract's maturity and even then, only if the contract is cash-settled. If the contract were physically settled, the option premium would reduce the tax basis of the stock received.

The general view, however, is that it is difficult to deconstruct the components of periodic payments paid with respect to prepaid forward contracts and that there are many possible ways in which such payments may be viewed as an economic matter. Because there is no direct guidance on point, dealers offering such contracts and investors generally agree to take a conservative approach to characterizing such payments. As a general matter, issuers and holders treat the entire periodic payments as ordinary income when received or accrued, according to the holder's method of tax accounting.⁶⁰

⁶⁰ See Farber, *supra* note 26, at 713-14.

A so-called "reverse convertible" note, an example of which is described in Annex A, Example 5, often is treated as an exception to the generally accepted treatment described in the text above. As an economic matter, an investment in a reverse convertible is equivalent to the investor writing a short-term "knock-in" put option, because the investor takes on only the downside risk with respect to the underlying asset, with no upside participation potential. In exchange for that, the investor receives very high periodic coupons that economically constitute option premium. As discussed above, under general tax rules, option premium is not taxable until the option expires or matures. The natural treatment of those coupon payments therefore would be to treat them as non-taxable when received. However, reverse convertibles also promise a return of the holder's investment, in addition to fixed-rate coupons, if the option is not exercised. Since this element, if considered on a stand-alone basis, is similar to debt, out of an abundance of caution, the tax disclosure for most reverse convertible notes generally states that holders must take a portion of the coupon into income on a current basis (generally computed at the dealer's comparable yield determined under principles similar to those described in the CPDI regulations). This

As is clear from Example 4 discussed above, this characterization often is disadvantageous to investors. A common example of disadvantageous treatment of periodic payments under current law arises when those payments economically represent dividends. The periodic payments do not retain the tax-advantaged treatment of the passed-through dividend distributions (e.g., characterization as qualified dividend income eligible for reduced tax rates,⁶¹ or as dividends qualified for the dividends-received deduction⁶²) although a sizable portion of the coupon may be attributable to such cash flows. In view of the tax-disadvantaged treatment of periodic payments on prepaid forward contracts, the popularity of coupon-paying instruments (including at least two ETNs)⁶³ demonstrates that the choice of whether the returns on the instrument are distributed currently or reinvested and paid at maturity is driven primarily by economic considerations and investor appetite for particular cash flows rather than by tax planning.

3. No imputation of interest income. Current law does not require that an investor accrue interest income on the payment made by the investor at the outset of a prepaid forward contract. Under a traditional (postpaid) forward contract, the time-value-of-money component of the forward price *economically* (but not as a tax matter) gives rise to interest expense for the purchaser and interest income to the seller. Under current tax law, however, the purchaser under a conventional forward contract is not allowed any deduction for the economic interest and the seller correspondingly has no taxable interest income.⁶⁴ The tax treatment of the purchaser is inconsistent with the

treatment is practical rather than theoretical, since, as described, the coupons primarily compensate investors for the substantial risk of loss that they take, not for the time value of money of their investment, and the usual maturities of reverse convertible notes are very short.

⁶¹ Section 1(h)(11).

⁶² Section 243.

⁶³ See *supra* note 37.

⁶⁴ This conclusion is straightforward, although it is generally assumed rather than explicitly stated in cases or rulings. For example, the conversion transaction rules of section 1258 require in certain

tax treatment that it would have obtained if it instead borrowed money from a bank and bought the underlying property, in which case the investor would obtain a tax benefit arising from the payment of interest. The only material difference between a prepaid forward contract and a conventional forward contract is that, under the prepaid forward contract, the investor makes a payment at the outset of the contract, and the seller will deliver the property (or the cash equivalent) at maturity. In that case, the purchaser's economic accruals of interest expense would net out against economic accruals of interest income; or equivalently, there is neither embedded interest expense nor embedded interest income.

No current tax authority expressly requires all payments under a forward contract to be made at maturity. Treating a prepaid forward contract in the same manner for tax purposes as a traditional forward contract is consistent with the general tax treatment of unrelated parties in commercial transactions that from time to time prepay obligations under forward contracts as a result of credit concerns.⁶⁵ The very limited authority available indicates that any interest-like element that might be imputed into a prepaid forward contract is not required to be accrued and does not constitute interest for U.S. federal income tax purposes.⁶⁶

circumstances that the interest component of a forward contract be treated as ordinary income to the seller under the forward contract. That recharacterization, however, applies only in limited circumstances, applies only to the character of income and not to its timing, and applies only to one party to the forward contract (the seller).

⁶⁵ Cf. Treasury regulation section 1.451-5 (providing rules for determining when prepayments received with respect to contracts to sell goods held for sale in the ordinary course of business must be included in income).

⁶⁶ See *Baltimore & Ohio Railroad Company*, 29 B.T.A. 368 (1933), *aff'd*, 78 F.2d 460 (4th Cir. 1935); GCM 20200, 1938-1 C.B. 206, *obsoleted by* Rev. Rul. 68-674, 1968-2 C.B. 609. In addition, as discussed in Section III.A, above, prepaid forward contracts traditionally have not been used as a source of corporate financing, and instead have been used as a means of providing an investment product to a derivatives dealer's customers. Accordingly, the issuer usually has no intent to borrow money, which generally has been viewed as one of the important indicia of a debt instrument. See, e.g., *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1908) (listing intent of the parties as criterion number one); Plumb, *supra* note 44, at 410-11.

Accordingly, under current law, the initial payment on a prepaid forward contract would require some current income accrual only if the prepayment caused the forward contract to be treated as debt for tax purposes. As discussed in Section III.A, above, there is a general consensus that a prepaid forward contract of the kind discussed herein does not constitute a debt instrument. The only rule of existing law that conceivably could apply to impute interest income to the prepayment feature of a prepaid forward contract is section 7872. That section recharacterizes payments on certain “below-market” loans as interest payments on an arm’s-length loan and a separate, offsetting transfer of funds. Section 7872 applies only to (i) certain gift loans and loans between related parties, (ii) “tax-avoidance” loans, and (iii) under regulations, other below-market loans. Section 7872 applies only to “loans,” however, and so does not apply to prepaid forward contracts.⁶⁷

IV. CURRENT LAW IS THE BEST APPROACH.

A. Current Treatment Is Based on Fundamental Tax Principles.

The current tax treatment of prepaid forward contracts as “open transactions” is based on a long-standing and fundamental principle for taxing investment income. That principle is that the change in value of an asset is not treated as “income” or “loss” for U.S. federal income tax purposes until the date of some specific event that causes the gain or loss to be “realized.”

The realization method is an admittedly imperfect system. Under a theoretically perfect system of *income* taxation, any annual net increment (or decline) in the value of a taxpayer’s assets would be taxed as current income (or current

⁶⁷ Proposed regulations under section 7872 provide generally that the term “loan” for these purposes should be interpreted broadly, and includes any transaction where one party permits another to use its money for a period of time. Proposed Treasury regulation section 1.7872-2(c)(1). The proposed regulations have remained in proposed form for decades, however. For a more detailed discussion of the non-application of section 7872 to prepaid forward contracts under current law, see Kleinbard & Nijenhuis, “Everything I Know About New Financial Products I Learned from DECS,” 593 *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 1095, 1123, Practising Law Institute (Oct.-Nov. 2003).

deduction) under what essentially amounts to an annual mark-to-market system.⁶⁸ A comprehensive system of that kind remains theoretical because it requires completely unrealistic conditions of perfect knowledge, complete liquidity, and costless administrability. On the other hand, under a theoretically perfect *consumption* tax system, none of an incremental increase in the investor's wealth would be taxed until actually spent on personal consumption.⁶⁹ While many economists believe that this system would have the least distortive effect on taxpayer behavior, it too remains theoretical at this point, in large part because of significant transitional obstacles associated with the shift⁷⁰ and because of the absence of a political consensus to move to a consumption tax.

Unlike either of these theoretically perfect tax systems, the U.S. income tax system has adopted as its essential principle the *realization* requirement for taxation of capital growth for reasons of fundamental fairness to investors and basic practical administrability.⁷¹ The tax policy reasons underlying the realization principle fundamentally relate to the principle that an accounting method must provide a

⁶⁸ The Haig-Simons model of income taxation generally defines economic income as consumption plus change in wealth. Haig, "The Concept of Income — Economic and Legal Aspects," *The Federal Income Tax* (1921) reprinted in *Readings in the Economics of Taxation* at 68-69 (1959); Simons, *Personal Income Taxation* at 103 (1938). See also Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 *Harv. L. Rev.* 1113, 1114 (1974); Kleinbard & Evans, "The Role of Mark-to-Market Accounting in a Realization-Based Tax System," 75 *Taxes* 789 (Dec. 1997) ("Such a tax on accretion (a mark-to-market approach) is generally viewed as the most theoretically desirable of all the various systems of taxing income, since only mark-to-market will consistently measure and levy tax on a person's 'economic income' or Haig-Simons income."); Halperin, "Interest in Disguise: Taxing the Time Value of Money," 95 *Yale L.J.* 506, 508-09 (1986); Shakow, "Taxation Without Realization: A Proposal for Accrual Taxation," 134 *Penn. L. Rev.* 1111, 1118-20 (1986).

⁶⁹ The President's Tax Advisory Panel on Federal Tax Reform, "Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System" at 20-21 (Nov. 2005) at http://www.taxreformpanel.gov/final-report/TaxReform_Ch3.pdf; see also Andrews, *supra* note 68, at 1123-24.

⁷⁰ See, e.g., Goldberg, "The Aches and Pains of Transition to a Consumption Tax: Can We Get There From Here?" 26 *Va L. Rev.* 447 (2007).

⁷¹ The genesis of the realization requirement is generally attributed to the Supreme Court's decision in *Eisner v. Macomber*, 252 U.S. 189 (1920), where the Supreme Court ruled that a stock dividend (*i.e.*, a pro-rata dividend on stock of a company paid with additional stock of that company) did not constitute taxable income to a shareholder.

reasonable degree of certainty and consistency — that is, the value of an item of income or expense that is recognized for tax purposes should be objective and verifiable. To that end, there are at least three main tax policy reasons for postponing taxation on capital growth of investments: (i) impermanence, (ii) lack of liquidity, and (iii) difficulty of valuation.⁷²

The most important tax policy reason to observe the realization requirement is the impermanence of accreted values. Until such time as the gains with respect to a contract are “realized” — that is, are received or become fixed in amount — gains that may have accreted in one taxable year may simply disappear in their entirety, or even turn into losses, in another year.

The valuation policy concern relates to the administrability of the income tax system. The Supreme Court endorsed the realization doctrine on this ground in *Cottage Savings Ass’n. v. Commissioner*, stating that “[u]nder an appreciation-based system of taxation, taxpayers and the Commissioner would have to undertake the ‘cumbersome, abrasive, and unpredictable administrative task’ of valuing assets on an annual basis to determine whether the assets had appreciated or depreciated in value.”⁷³

The liquidity policy concern is that, in the absence of a sale of the asset, a taxpayer does not have cash available to pay its taxes. It is undesirable to construct a tax system that would force taxpayers to sell some of their assets solely for the purposes of paying taxes. That is one illustration of a more general point that a tax system should limit any distortions to taxpayers’ economic behavior, and in particular

⁷² See Chirelstein, *Federal Income Taxation*, at 72 (6th ed. 1991); Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, ¶15-16 (2d ed. 1989); Evans, “The Realization Doctrine After *Cottage Savings*,” 70 *Taxes* 897, 898 (Dec. 1992).

⁷³ *Cottage Savings Assn. v. Commissioner*, 499 U.S. 554, 559 (1991) (quoting Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts*). In contrast, the Supreme Court stated that “[a] change in the form or extent of an investment is easily detected by a taxpayer or an administrative officer” (quoting Magill, *Taxable Income*, at 79 (rev. ed. 1945)).

should not provide a non-economic incentive for taxpayers to invest in one type of asset over another. If the tax rules ignored liquidity concerns, taxpayers would have a tax-driven incentive to invest in assets that pay returns sufficient to cover any taxes arising from the asset, rather than potentially more economically beneficial assets that do not pay returns of that kind.

These issues can be seen most clearly in the case of an illiquid asset like a house used as a personal residence. The case is very strong for not taxing any changes to a home's value, because all of the reasons discussed above are implicated. The value can decline, as current markets demonstrate, eliminating any "paper" gains; it is notoriously difficult to value unique assets such as real estate; and finally, taxing an increase in the value of a house in the absence of cash can produce extreme hardship for the taxpayer. The latter concern is a highly practical one, as illustrated by stories about senior citizens on fixed incomes being forced out of their long-time homes because of increases in property taxes imposed on the assessed increase in the values of their homes.⁷⁴

In the case of stock traded on a stock exchange, the valuation concern obviously is obviated, but the policy issues relating to impermanence and liquidity remain. Consequently, if an investor holds a share of common stock that increases in value, the investor is not required to pay tax on any such increase until he or she sells the share or until the corporate earnings that have produced that increase are distributed in the form of cash. In this case as well, the realization requirement serves several important goals. It ensures that the taxpayer has cash to pay the tax when the

⁷⁴ Because of this concern, a number of states have enacted various deferral programs and exemptions from property taxes for senior citizens and the disabled. See, e.g., Adler, "How you can Limit Pain of Property Tax Increases," *Chicago Tribune* (June 13, 2004), available at http://www.chicagotribune.com/classified/realestate/over55/chi-0406130284jun13_0_1015207.story; Moran, "California's Senior Citizen Property Tax Relief," OLR Research report 2000-R-0836 (Sept. 22, 2000), available at <http://www.cga.ct.gov/2000/rpt/olr/html/2000-r-0836.htm>; Dahl, "Senior Citizens work off their Tax Bills," *Boston.com* (Mar. 23, 2008), available at http://www.boston.com/bostonglobe/regional_editions/overridecentral/2008/03/senior_citizens.html.

tax is due and that, as a practical matter, the amount of the tax can be easily determined, both because the amount of income is final, and because the amount of income can actually be computed. It also avoids creating a non-economic incentive for taxpayers to invest in dividend-paying stocks rather than non-dividend paying stocks that may have more growth potential.

Another aspect of the realization principle is the fundamental accrual principle that contingent items of expense or income generally are not recognized for tax purposes until the contingency to which they are subject is resolved.⁷⁵ As discussed below, some limited exceptions to this general rule exist for certain types of financial instruments. In our view, those exceptions are narrow and do not signal any general departure from the realization system. More importantly, these exceptions apply only in situations that are materially different from investment in prepaid forward contracts and therefore should not serve as potential guides for designing tax rules for prepaid forward contracts.

SIFMA believes that the realization principle is the appropriate basis for taxing prepaid forward contracts, for all the reasons described above. The contingent

⁷⁵ Under the Treasury regulations codifying accrual accounting principles, a taxpayer recognizes income when “all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.” Treasury regulation sections 1.446-1(c)(1)(ii)(A) and 1.451-1(a). The leading cases deal with the application of the “all events” test to deductions, rather than income inclusions. *E.g.*, *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986) (applying the “all events” test, operator of progressive jackpot slot machines could deduct jackpot amounts accumulated but not yet won because by state law it could not reduce such jackpots). The same standard, however, applies to items of income. *E.g.*, *Thompson v. Commissioner*, 489 F.2d 288 (4th Cir. 1974) (subcontractor did not have to report income when he performed work because he did not receive payment until later year because of disputed claim); *Smith v. Commissioner*, 424 F.2d 219 (9th Cir. 1970) (lease payment contingent upon reaching agreement on related issues did not accrue until agreement reached); *Ringmaster, Inc.*, 21 T.C.M. 1024 (1962) (accrual of sales proceeds not allowed because contingent upon inspection and acceptance); *United States v. Harmon*, 205 F.2d 919 (10th Cir. 1953) (contractor did not accrue contract payment upon completion of work because contingent upon final audit and acceptance); Rev. Rul. 84-31, 1984-1 C.B. 127 (involving a “take or pay” gas purchase contract, the IRS ruled that “while there were in fact deficiency takings for the period . . . the amount thereof was not fixed and determinable [at end of that period] . . . Therefore, [the taxpayer] is not required under the all events test . . . to include the deficiency taking amounts in gross income for its tax year [which included that period].”).

returns on a prepaid forward contract (whether or not notionally “credited” to the investor) are impermanent and remain subject to the risk of loss until the maturity of the contract. These ephemeral gains may evaporate, and even turn into overall losses, because investors in prepaid forward contracts may lose all or a substantial portion of their investment. Taxing such “phantom” returns before they are received or become fixed strikes us as fundamentally unfair and prone to significant timing distortions. The unfairness of such treatment could be exacerbated by the fact that investors in prepaid forward contracts that do not pay current coupons also might not have cash on hand and might be forced to dispose of investments solely in order to pay the tax on these paper gains. Finally, since most prepaid forward contracts do not actively trade on exchanges and do not have readily observable market prices, valuation of such contracts could be difficult.

The current tax treatment of prepaid forward contracts takes all these considerations into account. Taxation of contingent returns is postponed until such returns become fixed, while any cash coupons generally are taxed as ordinary income at the time they are received or accrued by the holders. As a result, under current law, investors in prepaid forward contracts are taxed at the earliest moment when all of the policy reasons for the realization requirement are satisfied — that is, at the time when returns have become certain and easy to measure and when the investors have cash in hand to pay the tax.

B. Departures From the Realization Principle Are Narrow.

Although the realization principle has remained fundamental to the U.S. tax system, over time, several exceptions to the realization principle have been introduced in taxing investment income. Under these exceptions, the main instances where taxpayers are taxed on income even though they have not received cash fall into three categories: (i) constructive receipt; (ii) accrual of a time-value-of-money component with respect to debt; and (iii) mark-to-market of certain regulated traded

(and substantially similar) contracts. These categories impose tax on cash that is either immediately available to the taxpayer, or certain to be received, or on amounts that are viewed as direct substitutes for such cash. Another category of rules operates not by literally departing from the principle that tax arises when cash is paid or fixed in amount, but rather by recharacterizing long-term capital gain when it is received as ordinary in whole or in part and imposing an interest charge on any recharacterized income, with the economic effect of treating those investment returns as if they had been realized over the period to which such growth/return theoretically relates.

The exceptions discussed below are designed to respond to different theoretical and practical tax concerns and have been narrowly crafted. These rules apply only to instruments that, unlike prepaid forward contracts, do not implicate all of the three tax policy reasons for adhering to the realization principle. Fundamentally, these exceptions demonstrate why a practical tax system cannot wholly abandon realization precepts.

1. Constructive receipt. The constructive receipt doctrine generally stands for the proposition that if a person is entitled to receive cash (for example, as compensation for performing a service), he or she cannot avoid current taxation by asking that the cash be paid at a later time. Instead, the taxpayer is deemed to have constructively received the income and is taxed on it as if such income had been received at the time it was initially payable.⁷⁶

⁷⁶ As a general matter, constructive receipt applies to cash method taxpayers. See Treasury regulation section 1.451-1(a) (“Under the cash receipt and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received.”).

The constructive receipt doctrine has been developed primarily in the context of compensation for personal services and anticipatory assignment of income where taxpayers chose either to defer or assign to others income which they had the right to receive in cash. See, e.g., *Hicks v. Commissioner*, 314 F.2d 180 (4th Cir. 1963) (employee taxable on income deferred under a profit-sharing arrangement where there was an election to receive cash immediately); *Helvering v. Horst*, 311 U.S. 112 (1940) (holding father taxable on interest coupons detached from bonds and given to son); *Lucas v. Earl*, 281 U.S. 111 (1930) (holding that husband was taxable on compensation for future services paid to his wife under anticipatory arrangements); and *Corliss v. Bowers*, 281 U.S. 376 (1930) (holding that grantor of trust is taxed on income actually received by trustee because grantor enjoys the benefit of the discretion to use

Section 305(b)(1) serves as one example of the application of constructive receipt in an investment context. Generally, a stock dividend on common stock distributed pro rata to all shareholders is not taxable.⁷⁷ Even if those conditions are satisfied, however, section 305(b)(1) taxes *all* shareholders on the stock dividend distribution if *any* shareholder can elect to receive the dividend in cash (or other non-stock property), even if none actually does elect to receive cash. Section 305(b)(1) is based on the theory that the shareholder, by electing a stock dividend, has constructively received the alternative cash or property dividend, and then reinvested it in the corporation.

The same idea of receipt and reinvestment of income underlies the taxation of automatic reinvestment plans in mutual funds or dividend reinvestment plans more generally.⁷⁸ Mutual funds are required to distribute currently their net ordinary income and capital gains. Many shareholders choose to receive those distributions in cash. Others choose to have them automatically reinvested in additional mutual fund shares. Shareholders who make that election are taxed currently on the distributions, even though they do not actually receive any cash. Again, the reason for current taxation is that the shareholder is entitled to a current receipt of cash, but chooses to turn his or her back on it.

Prepaid forward contracts do not raise constructive receipt issues, since any coupons paid are paid in full to all investors and there are no rights to withdraw any other amounts prior to the contract's maturity.

the income to fund the trust); *Commissioner v. Sunnen*, 333 U.S. 591 (1948) (taxing husband who assigned to his wife his rights to royalties from a controlled family corporation licensed to use his inventions).

⁷⁷ Section 305(a); see also *Eisner v. Macomber*, 252 U.S. 189 (1920).

⁷⁸ See, e.g., Rev. Rul 77-149, 1977-1 C.B. 82 (dividends reinvested through an automatic "dividend reinvestment plan" are treated as distributions of property governed by Section 301); PLRs 8118031 (dividends automatically reinvested in additional shares of the mutual fund under dividend reinvestment plans qualify as distributions for purposes of section 857 and related provisions); 8111080 (same); and 8111066 (same).

2. Original issue discount, CPDI and NPCs. As a general matter, an investor in a debt instrument that pays current interest coupons is required to pay tax on the interest when paid or accrued.⁷⁹ In addition, under the OID rules, an investor in a debt instrument issued at a more than *de minimis* discount must pay tax on that discount as it accrues. The theory here is that the discount is simply a substitute for coupon interest, and should be taxed as such.

To take a simple example, assume that a debt instrument pays 6 percent annually and \$1000 in five years, at a time when prevailing interest rates are 6 percent. An investor will buy that debt instrument for \$1000. If the debt instrument pays only a 4 percent coupon, however, an investor would be willing to invest only approximately \$916, so that the bond would be issued at a discount of about 8.4 percent. Economically, the discount bond is equivalent to the investor paying \$1000 for a bond under which the investor is paid 4 percent annually and the other 2 percent in a lump sum on day 1, in an amount of about \$84. Alternatively, the discount bond could be viewed as the equivalent of the combination of two bonds: (i) investor pays \$1000 and receives \$60 interest annually, and (ii) investor borrows \$84 on day 1, and repays it in five annual \$20 installments. There is never any uncertainty about *whether* the holder will receive the “2 percent” cash on the discount bond, or *how much* it will receive. The

⁷⁹ Section 61(a)(4). The generally accepted definition of “interest” for federal income tax purposes is “compensation paid for the use or forbearance of money,” or, alternatively, “the amount which one has contracted to pay for the use of borrowed money.” *Deputy v. DuPont*, 308 U.S. 488, 498 (1940); *Old Colony R. Co. v. Commissioner*, 284 U.S. 552, 560 (1932). Although this definition of interest is most commonly employed in the context of section 163, see, e.g., *Deputy v. Dupont*, 308 U.S. at 498; *Fort Howard Corp. v. Commissioner*, 103 T.C. 345, 370 (1994); *Blitzer v. United States*, 684 F.2d 874, 882 (Ct. Cl. 1982); *Al S. Reinhardt*, 75 T.C. 47, 51 (1980); *Richard C. Goodwin*, 75 T.C. 424, 440 (1980); Rev. Rul. 74-187, 1974-1 C.B. 48; Rev. Rul. 72-315, 1972-1 C.B. 49; Rev. Rul. 69-188, 1969-1 C.B. 54, amplified by Rev. Rul. 69-582, 1969-2 C.B. 29, the same definition is widely used by the courts and the IRS for a variety of different contexts and Code sections, see, e.g., *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965) (characterization of revenue as capital gain versus ordinary income under former sections 117 and 1232); *Starker v. United States*, 602 F.2d 1341, 1356 (9th Cir. 1979) (sections 1031 and 1034); *New England Mut. Life Ins. Co. v. Welch*, 153 F.2d 260, 263 (1st Cir. 1946) (former section 203 dealing with deductions for life insurance companies); Rev. Rul. 80-143, 1980-1 C.B. 19 (section 103); Rev. Rul. 79-349, 1979-2 C.B. 233 (section 512); Rev. Rul. 76-413, 1976-2 C.B. 214 (section 856).

only difference between the par bond and the discount bond is *when* the cash is received.

The Supreme Court in *United States v. Midland-Ross*⁸⁰ recognized that any amount realized on the sale or disposition of debt that was attributable to earned discount was merely a substitute for interest income. Following this reasoning, the Supreme Court ruled that such substitute income must be treated as ordinary interest income rather than capital gain. Congress subsequently enacted section 1272 (originally, section 1232), which addresses the timing of the taxation of OID and now requires that a debtholder must be taxed on a current basis with respect to OID.⁸¹ Since OID is viewed as an economic substitute for current coupons (or may even be viewed as actually providing available cash by prepaying coupons on day 1, as discussed above), the lack of cash in hand (liquidity) is not viewed as determinative. And because OID income is certain to be received, the OID rules do not violate the fundamental realization principles that income should be fixed in amount — that is, permanent and readily valued — before it is taxed.

The rules that require current taxation of future returns that are certain in amount have been extended in limited situations to debt instruments that provide for returns *contingent* in amounts. Like OID, those contingent returns are viewed as substitutes for a current coupon that would otherwise have been received, and therefore as compensation for the time value of money lent to an issuer.

There is a body of case law, for example, holding that “income bonds” constitute debt and their coupons constitute interest for U.S. federal income tax

⁸⁰ *United States v. Midland-Ross*, 381 U.S. 54 (1965).

⁸¹ See S. Rep. No. 494, 97th Cong., 2d Sess. 210 (1982) (showing distortions from the historic straight-line method, especially when applied to long-term deep-discount and zero-coupon bonds issued in the high-interest-rate environment of the 1970s and early 1980s).

purposes.⁸² Income bonds generally are bonds the interest on which is payable in an amount determined by reference to, and in some cases only out of, the earnings of the issuer. The basis for this conclusion is that coupons paid on those bonds were the agreed compensation for the time value of money and a mere substitute for conventional coupons. Similarly, the rules for “variable rate debt instruments” treat periodic interest as such even if it is determined by reference to the performance of stock, commodities, or other financial assets.⁸³

The “contingent payment debt instrument” rules take the substitution theory one step further, by providing for current taxation of contingent amounts to be received in the future.⁸⁴ Like other debt instruments, CPDIs guarantee an investor the return of all or virtually all of its investment. Some or all of the interest on a CPDI is contingent on the performance of a stock, commodity, or other financial asset, and is paid, generally, at maturity. For example, an investor may purchase a five-year principal-protected CPDI with a face value of \$1000 that promises to pay at maturity its face value amount, plus a return based on the appreciation of the S&P 500 index during

⁸² See, e.g., *Monon Railroad v. Commissioner*, 55 T.C. 345 (1970) (the leading “income bond” case characterizing 50-year income bonds as debt). See also *New England Lime Company*, 13 T.C. 799 (1949), acq. 1950-1 C.B. 4 (an instrument bearing 3 percent fixed interest with an additional 3 percent interest payable out of earnings was debt); *Lansing Community Hotel Corp.*, 14 T.C. 183 (1950), *aff’d*, 187 F.2d 487 (6th Cir. 1951), acq. 1952-1 C.B. 3 (a ten-year instrument was debt when it provided for 10 percent interest payable out of “net operating income”); *Kena, Inc.*, 44 B.T.A. 217 (1941) (payments equal to 80 percent of net profits of a borrower were interest for the purpose of determining whether the lender, which was owned by the borrower, qualified as a personal holding company); *Dorzback v. Collison*, 195 F.2d 69 (3rd Cir. 1952) (payments equal to 25 percent of the taxpayer’s net profits made to the taxpayer’s wife were deductible interest even though the payments exceeded the underlying indebtedness); Rev. Rul. 76-413, 1976-2 C.B. 213 (contingent interest received by a real estate investment trust was “interest” even though payable out of gross receipts or determined by sales of certain property); Plumb, *supra* note 44 *supra*, at 432 (“...if (as in the typical income bonds) payment of interest is conditional upon corporate earnings but requires no discretionary action, the debt will normally be recognized, whether the right to interest is cumulative or not — at least in the absence of additional significant factors indicative of equity.”). Cf. *Universal Oil Products Co. v. Campbell*, 181 F.2d 451 (7th Cir. 1950) (because the determination of net income was discretionary by the board of directors when the payment of interest was out of net income, the instruments were equity and not debt).

⁸³ Treasury regulation section 1.1275-5.

⁸⁴ See Treasury regulation section 1.1275-4.

the term of the CPDI. If the value of the S&P500 index increased by 20 percent, the investor would receive \$1200; if the value of the S&P500 index increased by 2 percent, the investor would receive \$1020; and if the index declined by 20 percent, the investor would receive back its \$1000, but would not realize any returns. Assuming that the issuer of the CPDI could issue a 5-year plain vanilla note that would pay an annual coupon of 6 percent, the investor for U.S. tax purposes would be required to accrue current interest on the CPDI at the annual rate of 6 percent and the issuer would be entitled to deduct interest at the same rate.⁸⁵ The fact that this rate is fixed throughout the term of the instrument, until the amount of contingent interest is determined, demonstrates that the contingent interest that the taxpayer is required to take into account — like conventional discount on a bond — is simply viewed as a substitute for the periodic interest that would otherwise have been paid, and therefore as compensation for money loaned.

The substitution principle also explains the tax rules applicable to “notional principal contracts” that have fixed nonperiodic payments.⁸⁶ As explained below, a fixed

⁸⁵ See Treasury regulation section 1.1275-4(b)(3)(i).

⁸⁶ See *generally* Treasury regulation section 1.446-3. A simple example of an NPC is an interest rate swap under which the taxpayer agrees, for a term of five years, to make annual payments to a counterparty in an amount equal to a floating interest rate such as the then-current London Interbank Offered Rate (“LIBOR”), multiplied by a notional principal amount of \$100 million, in exchange for the counterparty making simultaneous payments to the taxpayer in an amount equal to 6 percent multiplied by the same notional principal amount.

Prepaid forward contracts are not characterized as NPCs under Treasury regulation section 1.446-3. The regulations that provide timing rules for NPCs define an NPC as “a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.” Treasury regulation section 1.446-3(c)(1). For prepaid forward contracts where an investor makes only one payment at the inception of the contract and receives only a single payment at maturity, the absence of periodic payments takes such contracts outside the definition of an NPC quoted above. In addition, the term “notional principal amount” is defined as “any specified amount of money or property that, when multiplied by a specified index, measures a party’s rights and obligations under the contract, but is not borrowed or loaned between the parties as part of the contract.” See Treasury regulation section 1.446-3(c)(3). Under this definition, if the payout under a prepaid forward contract is determined based on the amount actually invested in the contract (that is, based on an actual, rather than notional “principal”), such amount cannot qualify as a notional principal amount, and the contract will fail the definition of an NPC.

nonperiodic payment is a substitute for what would otherwise be payments made during the life of the contract. A nonperiodic payment of this kind functions very much like discount on a bond. Accordingly, a “significant” nonperiodic payment is required for U.S. tax purposes to be treated as an embedded loan that generates current interest accruals.⁸⁷

To illustrate the point made above, consider the following. Assume that under an at-market 5-year interest rate swap with a notional principal amount of \$1000, a taxpayer would receive 6 percent annually and in return would pay a floating rate on the same notional principal amount. If the counterparty wanted to pay the taxpayer only 4 percent annually, the taxpayer would be willing to enter into the swap only if the counterparty paid the taxpayer something extra upfront to compensate it for the loss of the extra 2 percent payments, in an amount of about \$84. That is, the taxpayer would receive 4 percent annually and the other 2 percent in a lump sum on day 1. Economically, this lump sum payment has exactly the same function as the discount on the discount bond described earlier — it compensates the taxpayer for the fact that it will not receive a stream of payments equal to 2 percent times \$1000 over five years, and it is the economic equivalent of the issuance of an \$84 bond issued by the taxpayer that the taxpayer must repay in \$20 annual installments.

As the above example demonstrates, a “significant” nonperiodic payment is merely an advance on a stream of future periodic payments that are specifically provided for under the terms of the swap.⁸⁸ That is, as with the bond discount, if one takes into account only the fixed stream of payments, there is no uncertainty about *whether* the holder will receive the “2 percent” cash payments, or *how much* it will

⁸⁷ See Treasury regulation section 1.446-3(g).

⁸⁸ See Preamble to Proposed Treasury Regulation Section 1.446-3, 56 *Fed. Reg.* 31350, at 31352 (July 10, 1991), *reprinted in* 1991-2 C.B. 951 (noting that a lump-sum payment under [an NPC] may be identical to a loan).

receive.⁸⁹ The only difference between the at-market swap and the off-market swap is *when* the cash is received. Consequently, Treasury regulations require that this type of advance be taken into account over the life of the swap and, if it is “significant,” that it be treated as a loan from the counterparty to the taxpayer that gives rise to interest income and expense to the parties. This is effectively the same tax treatment that is required for the economically equivalent \$84 discount on the discount bond.

In all of these cases, therefore, the governing principle is that amounts that merely substitute for a fixed stream of payments that otherwise would be received should be taxed in a manner comparable to that fixed stream of payments. Because instruments that promise a fixed stream of payments are usually debt, most of these rules apply to debt. That is not coincidental; as discussed in Section III.A, above, risky instruments that do not promise investors the return of their investment generally must provide the promise, or the expectation, of higher, variable returns that compensate investors for taking that risk. It also is important to note that neither the regular OID rules nor the CPDI rules nor the swap rules take into account any changes in the *value* of the debt instrument or, in the case of the CPDI rules, changing expectations over time about the amount of the contingent payment. This point highlights the fact that these rules deal with advances on, or substitutions for, fixed streams of payments only, for which there are no valuation or impermanence concerns.

Prepaid forward contracts are very different in kind. The payment made by an investor to buy a prepaid forward contract is not in any sense an advance on or a substitution for fixed payments that would otherwise be paid to the investor.⁹⁰

⁸⁹ Of course, in real life, because floating interest rates will change there is no certainty that any specific amount will be paid on any payment date. But the parties determine the amount of the upfront payment (\$84) by discounting the 2-percent stream of fixed payments that otherwise would be paid to present value based on then-prevailing interest rates (6 percent) — that is, by treating the fixed stream of payments as independent of the floating stream of payments — and the tax rules simply follow that economic reality.

⁹⁰ It is important to distinguish substitutes for income that otherwise would be paid under the same instrument from potential substitutes for income that may be earned on alternative investments. Current

Moreover, as discussed elsewhere, except with respect to any stated coupons, prepaid forward contracts do not promise any fixed returns; and they are inherently risky financial instruments of the kind that raise all of the valuation, impermanence and liquidity concerns that form the basis of the realization principle.

3. Section 1256; mark-to-market. As Section IV.A, above, indicates, a mark-to-market timing regime is inconsistent with the realization principle. For that reason, it is a required method of accounting only in very limited circumstances.

Regulated futures contracts and other contracts that are traded on a regulated commodities exchange are subject to daily “variation margin” cash settlement rules, under which on a daily basis (i) if the contract loses value, the taxpayer must deposit in cash variation margin, or (ii) if the contract increases in value, the taxpayer is paid in cash variation margin that it is entitled to withdraw from its account.⁹¹ Section 1256 requires investors to mark such contracts to market, meaning that taxpayers must take into account for U.S. federal income tax purposes any unrealized gain or loss on any open contracts held at the end of the year. The potential harshness of this treatment is mitigated by a rule that treats the resulting gains and losses as 60 percent

tax law does not require that taxpayers recognize opportunity-cost income on foregone investments. For example, a taxpayer that holds cash that is not invested and therefore does not generate any income is not required to accrue income on that cash, absent abuse. Similarly, a taxpayer that chooses to invest in a mutual fund rather than buy the underlying stocks is not required to take income into account in the same manner as if it had bought the underlying stocks. Therefore, payments under a prepaid forward contract should not be viewed as a substitute for income that the investor would in theory be able to earn on an alternative investment (such as, for example, interest on a deposit of a collateral under a post-paid forward contract). *Compare* Rev. Rul. 2003-7, 2003-1 C.B. 363 (prepaid variable share forward contract treated as a single contract for sale of stock), with Rev. Rul. 2003-97, 2003-2 C.B. 380 (interest taken into account on a forward/bond unit only if the bond is truly separate from the forward contract).

⁹¹ See S. Rep. No. 144, 97th Cong. 1st Sess. 158 (July 6, 1981) (describing regulated futures contract as a contract marked to market under a daily cash flow system of the type used by U.S. futures exchanges). This feature has been proffered as a reason to permit or require mark-to-market accounting since the IRS's early rulings allowing the use of mark-to-market for cotton futures held by cotton dealers. For an example of the early rulings on mark-to-market accounting, see Appeals and Review Memorandum 135, 4 C.B. 67, 69 (1921). See also Solicitor's Memorandum 5693, V-2 C.B. 20 (1926) (amending and clarifying A.R.M. 135 in this regard).

long-term capital gain or loss, even if the contracts were not held for more than one year.⁹²

The section 1256 mark-to-market rule is an application of the constructive receipt doctrine. It applies to financial instruments that grant investors the ability almost instantaneously to withdraw in cash any increase in the instrument's market value (to the extent it exceeds margin requirements), due to the variation margin feature described above.⁹³ Any increases in the value of the taxpayer's positions, therefore, are deemed to be "realized" under the constructive receipt doctrine. This ability to monetize the changes in the market value of exchange-traded assets without the sale of the assets was considered essential to overcome the argument that mark-to-market taxation was unfair.⁹⁴ In addition, these instruments generally are very short-term, so that impermanence of gains does not pose a significant concern, since any gain can be expected to be realized in the very near future and thus to be transformed permanently

⁹² Section 1256(a).

⁹³ Section 1256 also applies to foreign currency contracts that are traded on an interbank market (and not traded on an exchange) although they are not subject to a variation margin system, and to "nonequity" options (for example, options on futures contracts on commodities or a stock index) although only writers, and not holders, of such options are subject to daily margin requirements. We understand that the general rule under section 1256 was extended to foreign currency contracts and to "nonequity" options (defined as all options other than options on individual stocks and on stock indices that are too narrowly based to meet the standards established by the Commodity Futures Trading Commission for being traded on as a futures contract on a futures exchange), because participants in such markets wanted the same tax rules to apply to substantially similar instruments – for example, futures contracts, on the one hand, and options on such futures or their underlying indices, on the other -- that were traded in similar fashion. See Wetzler, "The Tax Treatment of Securities Transactions Under the Tax Reform Act of 1984," 25 *Tax Notes* 453, 459 (Oct. 29, 1984) (discussing the history of the expansion of the reach of section 1256). Like futures contracts, foreign currency contracts and nonequity options were generally short-term instruments that could be readily valued.

⁹⁴ See S. Rep. 144, 97th Cong. 1st Sess. 157 (July 6, 1981) ("The committee bill adopts a mark-to-market system for the taxation of commodity futures contracts. This rule applies the doctrine of constructive receipt to gains in a futures trading account at year-end. ... Because a taxpayer who trades futures contracts receives profits as a matter of right or must pay losses in cash daily, the committee believes it appropriate to measure the taxpayer's futures' income on the same basis for tax purposes."); *Charles L. Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993) (rejecting the taxpayer's argument that section 1256 was unconstitutional because it taxed unrealized gains on taxpayer's futures unsold at year end, and comparing right to receive futures gains in cash to right to receive interest credited to a bank account).

into cash. Furthermore, these instruments present no valuation issues, because they are traded on an exchange.

Section 475 also establishes a mark-to-market regime for securities and derivatives positions held by dealers and, pursuant to an election, by certain electing dealers and traders. The tax policy rationale underpinning section 475 is completely different from that discussed above, and is inherently limited to a very small group of taxpayers. Section 475 reflects a tax policy concern about distortions in the timing of income that would arise under the realization principle because securities and derivatives dealers regularly hedge their customer positions, and the realization of gains and losses on those hedges may be either earlier or later than the realization of the corresponding economic losses and gains on customer positions. In addition, unlike investors, dealers can readily buy and sell physical securities to trigger tax losses without fear of the wash sale rules, so the mark-to-market regime (and its predecessor, lower-of-cost-or-market) permits dealers to take losses without disrupting normal market trading. Finally, requiring a mark-to-market method of tax accounting for dealers is appropriate because dealers also are required to use mark-to-market for customer positions for financial accounting purposes, because no other method is viewed as clearly reflecting income.

4. Section 1260 and passive foreign investment corporation rules.

The “constructive ownership” rules of section 1260 are a misnomer. They do not treat a taxpayer as “owning” the assets that underlie a section 1260 transaction, but rather potentially recharacterize long-term capital gain from the transaction. The passive foreign investment company rules similarly recharacterize gain on the disposition of shares in a PFIC as ordinary. Taxpayers are permitted in certain circumstances to mark their positions to market. Both of these sets of rules are not technically departures from the realization principle, which is a timing rule. But because they impose an interest

charge on recharacterized income, in practice they have the economic effect of current inclusion of income that has not been received.

Section 1260 limits the amount of any long-term capital gain resulting from the disposition or settlement of a section 1260 transaction, such as a total return swap or forward contract on certain “pass-thru” investments, to the amount of long-term capital gain that would have resulted if the taxpayer had owned the underlying property for the same period that it held the contract. These rules were intended to address potential abuse situations where, for example, a potential investor in shares of a hedge fund treated as a partnership for U.S. tax purposes (or in some other transparent entity generating current ordinary income) would instead enter into a swap or forward contract on the shares, with the intended result that the taxpayer (a) had no current income from the hedge fund, and (b) derived all of its economic income from the transaction in the form of long-term capital gain on termination or disposition of the contract. That is, section 1260 is intended to prevent deferral and conversion of ordinary (and short-term capital gain) income that could arise in cases involving a synthetic direct investment in a static, relatively illiquid, and clearly identifiable and unique asset, such as shares in a specified hedge fund. As discussed below in Section V.B.2, it does not operate very well outside that context. Moreover, its draconian evidentiary rules make it difficult for taxpayers to tolerate uncertainty as to whether it will apply.⁹⁵

A passive foreign investment company (“PFIC”) is, very generally, a foreign company whose sole or principal assets are investment assets. The PFIC rules were intended to address the problem of the “incorporated pocketbook,” meaning transactions in which taxpayers who could have held investment assets directly instead

⁹⁵ Section 1260(e) (“The amount of the [long-term capital gain that would have resulted if the taxpayer had owned the underlying property for the same period that it held the contract] with respect to any financial asset shall be treated as zero unless the amount thereof is established by clear and convincing evidence.”). See *also* S. Rep. No. 120, 106th Cong., 1st Sess. 204 (1999) (Unless the taxpayer establishes the amount of the net underlying long-term capital gain by clear and convincing evidence, the amount is deemed to be zero, and all of the gain thus will be treated as ordinary.)

held them through a foreign corporation. They operate very generally in a manner similar to section 1260.⁹⁶

The PFIC rules are so toxic that it is thought that investors generally will not invest in PFIC shares unless they can mark the shares to market or make a “qualified electing fund,” or “QEF” election, under which the investor is taxed on a current basis on the net earnings of the PFIC. The QEF rules are sufficiently complex and onerous in their own right that, as a practical matter, investments in PFICs generally are made only by sophisticated investors who have the capability to understand and apply the rules, such as insurance companies or hedge funds. Indeed, some brokers have a practice of not marketing PFIC stock to individuals, other than perhaps select high-net-worth individuals who rely upon experienced tax advisors who may be expected to be able to deal with the rules. That is, as a broad generalization, the effect of applying the PFIC rules is not to tax investors on their economic income but rather to prevent potential investors in PFIC shares from making the investment. The application of section 1260 to a transaction is similarly noxious.

C. Any Alternative Should Be Better, Not Just Different.

Policymakers at both Treasury and the Congressional level have raised a number of tax policy concerns with respect to the application of current law to prepaid forward contracts, and various proposals have been made in various forms to address those concerns. In Parts V and VI below we address a number of different possible tax regimes that could be imposed. As we discuss there in more detail, in our view, all of the possible alternatives for taxing prepaid forward contracts have significant complexities and other drawbacks as a matter of both internal tax policy logic and practical implementation.

⁹⁶ See Sections 1291-1297. The taxation of PFICs is built on the idea of denying U.S. persons the value of deferral of U.S. taxation on all passive investments channeled through foreign entities. See Isenbergh, *International Taxation*, ¶ 80.1.2 (4th ed. 2006).

If a separate regime for prepaid forward contracts were to be developed, an important policy decision would be whether to craft different tax rules based on different economic or financial features, which, as discussed in Section II.A, above, may differ significantly for various contracts. The differences in riskiness of the underlying assets, types of returns that investors benefit from, and complexity of the underlying formulas make developing a single set of tax rules to address all prepaid forward contracts either impossible, or deficient in internal consistency and capable of providing only very rough justice. On the other hand, a set of rules that would make fine distinctions among various types of prepaid forward contracts likely would lack clarity and administrability. There is no guarantee that either approach would improve the balance between the taxation of derivative transactions and the taxation of referenced assets. Both approaches could, however, significantly diminish the clarity, consistency, and administrability of the tax system. In our view, a more promising alternative to the approaches discussed above would be for the Treasury and IRS to retain the current tax framework that treats prepaid forward contracts as open transactions and to address any features inconsistent with such treatment on a case-by-case basis.⁹⁷

Equally important, in light of the fact that the current tax system already has several schemes for taxing financial instruments with contingent payments (such as NPCs, CPDIs, options, and traditional forward contracts), we believe that in the interests of clarity, consistency, and administrability, it would be bad tax policy simply to add one more separate set of rules applicable to prepaid forward contracts. The adoption of any of the alternative systems of taxation of prepaid forward contracts proposed to date

⁹⁷ For example, at the same time as the issuance of the Notice, the IRS issued Revenue Ruling 2008-1, which addressed a transaction in form structured as a prepaid forward contract with respect to a foreign currency. The IRS held that the transaction in fact is characterized as a foreign currency denominated debt instrument under section 988 and investors therein are required to accrue interest income on a current basis. The issuance of the Revenue Ruling demonstrates that the IRS is ready and well equipped to issue prompt guidance with respect to instruments with features considered to be troubling on a case-by-case basis.

would create a new framework that would not be aligned with the existing systems for taxing other financial products that have contingent payments. If it is determined that changes to the taxation of prepaid forward contracts are necessary, a better alternative would be to undertake a comprehensive project to develop a uniform set of rules addressing *all* financial instruments with contingent payments regardless of their form, or at least those financial instruments closely related to prepaid forward contracts, namely CPDIs and NPCs with contingent nonperiodic payments.

It is important to keep in mind that by comparison to any perfect theoretical set of rules, the realization principle is by definition imperfect. It is inherent in the application of the realization principle, for example, that the taxation of economic income, (e.g., the growth in value of a stock investment) and the tax deduction of economic loss (e.g., the decline in value of a stock investment) will be deferred. As a result, in our view, the argument for changing current law should not be simply that the current rules for taxing prepaid forward contracts are deficient in some way. Rather, the argument must be that there is a *better* way to tax them.

V. POSSIBLE ALTERNATIVE REGIMES.

As discussed above, if new rules are issued affecting prepaid forward contracts, we believe that a single set of rules applicable to all prepaid forward contracts is likely to overtax some instruments and arguably undertax others in ways that are not desirable from a tax policy perspective. They are, however, in theory more likely than rules applicable only to one or more subsets of prepaid forward contracts to satisfy the conditions of clarity, consistency, and administrability that we think are essential in this complex and ever-changing area. Whether those conditions can in fact be satisfied depends on the choice of rules. We discuss here a mark-to-market regime, several variants of a regime based on “looking through” a prepaid forward contract to the referenced assets and income thereon, and finally an accrual or debt-characterization regime. As discussed in more detail below, we believe the first two of those choices are

completely inconsistent with fundamental tax principles and/or completely unworkable. We also have significant concerns about an accrual regime.

Before turning to discussion of possible alternatives, it is important to identify the policy concerns they are supposed to address. Policymakers have raised two general concerns with prepaid forward contracts, and specifically with ETNs. The first is that the formula that determines the ultimate payment due on a prepaid forward contract may take into account a dividend or interest return on the referenced assets. The second is that the referenced assets themselves may change over time, either because the referenced assets are by their nature short-term, such as commodity futures contracts, or because the payment formula provides that a component of an index may be redefined from time to time, for example, when one stock is removed from a stock index and another is added.⁹⁸

These have been characterized as “unique” features of ETNs. In fact, however, they are not unique. As described earlier, for example, the forward purchase price on every forward contract on dividend-paying stock takes into account both dividends on the reference stock and interest. The dividend and interest components may not always be evident, but they are there. For example, in the case of equity index futures contracts, those contracts are very short-term and there is therefore not much risk that dividends or interest rates will change during their term. Accordingly, equity index futures contracts are priced by reference to anticipated dividends and a fixed interest rate and so just state a purchase price without explaining its economic components. Longer-dated forward contracts on stock, by contrast, generally have some provision for changes in dividend amounts over their life, and may also take variable interest rates into account. The general point that both costs and returns attributable to a direct investment in the underlying asset are taken into account in

⁹⁸ See The JCT Derivatives Report, *supra* note 18, at 29; the Treasury Testimony, *supra* note 3, at 5.

pricing a forward contract can also be seen from the fact that prices for futures contracts on some agricultural commodities are lower than spot prices for those commodities, because the futures prices take into account the considerable shipping, storage, and other carry costs associated with those physical commodities.⁹⁹ Conceptually, longer-dated contracts have exactly the same economic components as shorter-dated contracts.

Moreover, ETNs and other “total return” prepaid forward contracts do not, as some rhetoric suggests, simply “defer” the taxation of dividends on referenced assets. There is a great difference between (a) a hypothetical synthetic investment in a portfolio of stock in which dividends paid are notionally held for the investor’s benefit and paid out at maturity, in addition to the value of the stocks, and (b) a synthetic investment in the same stock portfolio in which any notional dividends are reinvested in additional stock. In the former case, the investor will receive the dividend amount under all circumstances, absent the bankruptcy of the issuer. In the latter, the investor is economically in a position comparable to investing in a portfolio of non-dividend paying stocks, meaning that the stock issuers are reinvesting their earnings rather than paying them out. That is true because the investor never has the right to withdraw those

⁹⁹ Backwardation is a futures market term to describe a downward sloping forward curve where the price of a commodity for future delivery is lower than the spot price, or a far future delivery price lower than a nearer future delivery. Although backwardation in some instances is viewed as a somewhat puzzling market phenomenon, there are several explanations of why backwardation occurs. As an alternative and sometimes in addition to the explanation related to embedded storage and shipping costs, some economists believe that backwardation reflects concerns about supply, intangible benefits of having immediate access to the commodity, and market premiums earned by long investors within a market dominated by investors taking short positions. See generally Keynes, *Treatise on Money*, ch. 29 (1930) (discussing the market premium theory for backwardation in commodities markets); Frechette & Fackler, “What Causes Commodity Price Backwardation,” 81-4 *Am. J. of Agr. Econ.* 761-771 (Nov. 1999) (reviewing the theories of backwardation), available at <http://www.allbusiness.com/north-america/united-states/339942-1.html>; Wright & Williams, “A Theory of Negative Prices for Storage,” *J. Futures Mkts* 9, at 1-13 (Feb. 1989) (same).

dividends, and because the amount that the investor will ultimately receive depends entirely on how the stock portfolio performs.¹⁰⁰

Turning to the other assertedly “unique” feature of ETNs, it is a common feature of any index intended to serve as a benchmark for a sector of the economy that its components change from time to time. There have been for many years financial products linked to such indices, including swaps, options and futures contracts. While most exchange-traded index contracts are marked to market (other than futures contracts on a narrow-based stock index), swaps and non-exchange traded options are taxed under normal cash or accrual methods of accounting. The Treasury regulations governing the timing of income from swaps explicitly acknowledge that index swaps constitute NPCs. Nothing in the regulations suggests that changes to the components of an index give rise to current taxation, and no policymaker or commentator that we are aware of has ever suggested that they should do so.¹⁰¹

Finally, as previously discussed, the economic terms of prepaid forward contracts vary widely. There are many prepaid forward contracts that have payment terms linked to a static asset or pool of assets (e.g., Annex A, Examples 3 and 4, which describe contracts linked to single stocks), and there are many prepaid forward

¹⁰⁰ To take a simplified single-stock example, assume that a taxpayer invests \$100 in a 30-year prepaid forward contract on one share of stock A, which pays an annual dividend equal to 3 percent of the stock A’s trading value at the end of that year. By the terms of the prepaid forward contract, the formula increases the “notional” investment in stock A by an amount equal to the dividend. At maturity, the investor will be entitled to cash equal to roughly 2.4 shares of stock A. If stock A has quadrupled in value, the investor will receive about \$970, of which \$400 represents value of the initial one share of stock. If stock A has fallen in value by 40 percent, the investor will receive about \$145, of which \$60 represents value of the initial one share of stock. The economic benefit to the investor of the 3 percent credit in the formula thus varies in these examples from \$570 to \$85, depending on the performance of the stock. If stock A did not pay dividends, but instead reinvested its 3 percent earnings at the end of each year, the result to the prepaid forward contract investor should be equivalent.

Prepaid forward contracts linked to total return commodity indices, where the interest component notionally credited to the contract is deemed reinvested in the collateral for the unleveraged exposure to the underlying index, could be viewed as operating under a similar principle, because the ultimate payment depends on the performance of the index. The analogy, however, is not perfect, since the credited amount derives from a different asset than the increased risk position.

¹⁰¹ Treasury regulation section 1.446-3(c)(1), (d). See also the discussion in note 58, *supra*.

contracts that have “price only” payment formulae, meaning that the formulae do not refer to, or notionally credit, dividends or other distributions on the referenced assets (e.g., Annex A, Example 1, discusses a contract that makes a payment at maturity linked to a *price return* index).

A. Mark-to-Market.

Section IV.A above discusses in detail the reasons why mark-to-market has not been adopted as a general rule for taxing investment assets, notwithstanding its apparent lure. As further discussed in Section IV.B.3 above, under current law mark-to-market is required generally only for short-term highly liquid financial instruments that provide current cash to investors, thus obviating or minimizing each of the three core reasons underlying the realization principle, or for dealers in securities who operate under special conditions not relevant to other taxpayers.

By contrast, the policies that sustain the realization system would apply with equal force to any proposal to adopt a universal mark-to-market system to prepaid forward contracts: (i) prepaid forward contracts generally have a medium or long term, so that any increase in value at the end of the year could disappear at any time; (ii) many prepaid forward contracts are not traded on exchanges and have no natural buyer other than the original issuer, so that valuation is not certain;¹⁰² and (iii) investors’ cash investment is still locked up in the prepaid forward contract.¹⁰³ A mark-to-market

¹⁰² One could envision a regime in which dealers were required to provide valuation information to taxpayers. We believe that it is entirely appropriate for dealers to be able to rely on their internal mark-to-market book numbers for purposes of their *own* tax returns. In view of the fact that the current Treasury regulations providing a safe harbor for reliance on book numbers impose a number of burdensome restrictions not consistent with current market practice, however, we believe that any questions about dealers’ ability to use their marks for their own tax purposes should be resolved before any consideration is given to requiring dealers to provide those numbers to third parties who will rely on them.

¹⁰³ Professor Alex Raskolnikov’s testimony before the House Ways & Means Committee on the treatment of derivatives recommended that Congress consider requiring a mark-to-market regime for all derivatives, presumably including prepaid forward contracts. He dismisses liquidity concerns by saying that middle-class taxpayers do not buy derivatives. See Statement of Alex Raskolnikov, Associate Professor of Law, Columbia Law School at a Hearing of the House Committee on Ways and Means, Subcommittee on Select Revenue Measures on the Treatment of Derivatives at 10 (Mar. 5, 2008), available at <http://waysandmeans.house.gov/media/pdf/110/raskolnikov.pdf>. Whatever the merits of that

system for all prepaid forward contracts thus would tax economic income that is phantom, fleeting, and the amount of which may be subject to dispute. This is not a better system than current law.

Financial instruments executed or traded on exchanges — in this case, ETNs — would not raise valuation issues. As a tax policy matter, however, ETNs are not different in kind from other prepaid forward contracts. Apart from the practical consideration that ETNs can be readily valued, there is no principled reason to distinguish such transactions from prepaid forward contracts that are not traded. Possible adoption of mark-to-market treatment of ETNs is discussed further in Section VI.B, below.

Notwithstanding these considerations, if some other new method of accounting is adopted for prepaid forward contracts, a mark-to-market election might alleviate some of the problems any such rules would give rise to. Accordingly, we recommend that if any new rules are adopted that would require taxpayers to pay tax on phantom income on prepaid forward contracts, that investors be permitted to elect mark-to-market.

B. “Look-Through” Approaches.

1. Summary of look-through approaches. Another potential alternative to the open transaction treatment that has been proffered is to “look through” to the underlying assets. This theoretical concept encompasses a number of different possibilities, including (a) rules that would take into account income items credited on referenced assets, such as dividends or interest, on a current basis; (b) rules that would take into account notional gain from the substitution or disposition of referenced assets, such as may arise when a stock index is rebalanced, on a current basis; and (c) rules like those of section 1260 that would not seek to impose tax on such income or gains on

statement with respect to options and swaps, it is demonstrably not true with respect to prepaid forward contracts.

a current basis, but would effectively do so through recharacterization of income when a prepaid forward contract is disposed of, plus an interest charge.¹⁰⁴

While the specific details of the approaches listed above may differ significantly, the key to each of these purported solutions to the tax policy issues posed by prepaid forward contracts is that they are premised on the assumption that a prepaid forward contract may be analyzed as an aggregate of the separate assets constituting its underliers. This approach may appear simple enough when the underlying asset is a single stock or a “static” (*i.e.*, unchanging throughout the term of the instrument) index or basket with “delta one” exposure, meaning that there is a one-for-one relationship between an increase or decrease in value of the referenced asset(s) and the prepaid forward contract. If the underlying asset represents a dynamic strategy, then this approach would require any notional dispositions of investments or reconstitutions of indices be treated as if an actual disposition of investments had occurred.

2. Problems with look-through approaches. As discussed in Part II, above, only some prepaid forward contracts currently provide simple “delta one” exposures to the underlying assets. Many prepaid forward contracts provide investors with non-linear risk profiles and complicated payouts achieved primarily through complex combinations of options to create customized exposures to the performance of equities, commodities, or some other underlying assets. Other prepaid forward contracts have embedded leverage, meaning that an investor’s gain or loss is a multiple of the change in value of a referenced asset, and/or both long and short positions. For example, an instrument described in Annex A, Example 1, provides leveraged exposure to the Nikkei 225 index. Another example is an ETN recently issued by Deutsche Bank,

¹⁰⁴ Another possible type of “look-through” approach would be to try to deconstruct a prepaid forward contract into its “component” financial instruments, such as a conventional forward contract and a bond. This is essentially an accrual proposal, which is discussed in Section V.C, below.

which offers investors exposure to two times the monthly inverse performance of the gold index.¹⁰⁵

The complexities involved in trying to “unbundle” these prepaid forward contracts into their “component” parts, and then to determine what rules would apply to take income or loss from the components into account, would be unmanageable, as discussed in more detail below. Any approach of this kind also would subject investors in prepaid forward contracts to tax rules that are *less* favorable than a direct investment in the referenced assets, or in a mutual fund investing in those assets, as discussed below. We do not believe that rules of this kind would be an improvement over current law.

As an initial matter, it is commonplace knowledge among finance professionals that the economic results of any financial instrument can be reconstructed by means of other financial instruments. As discussed above in Section II.A, as a matter of finance theory, there are many equally correct ways in which any prepaid forward contract may be characterized as a combination of different options. Under the basic finance concept of “put-call parity,” there is no single correct view as to the characterization of an instrument as a combination of particular basic financial pieces.¹⁰⁶

We believe that any approach that relies on deconstructing complex financial instruments or looking through to the taxation of the underlying assets would be impractical for any non-delta one instrument, and would be doomed to fail. In many cases, it would be nearly impossible to determine what those particular assets would be. For example, should an instrument that provides for leveraged capped returns

¹⁰⁵ See Deutsche Bank Gold Double Short ETNs, *supra* note 36.

¹⁰⁶ See, e.g., Kau, “Carving Up Assets and Liabilities — Integration or Bifurcation of Financial Products,” 68 *Taxes* 1003 (Dec. 1990) (demonstrating how the economic effects of a simple fixed-rate borrowing in U.S. dollars can be replicated through at least 13 different transactions that would have different effects under U.S. tax law); Kleinbard, “Beyond Good and Evil Debt (And Debt Hedges): A Cost Of Capital Allowance System,” 67 *Taxes* 971 (December 1989) (discussing the difficulty of determining where the line should be drawn if deconstruction were to be undertaken); Brown, *supra* note 26.

similar to that described in Annex A, Example 1, be viewed as a combination of a long position in the stock with several call options? Which combination of options would be the “right” one? If a deconstruction approach were to be applied on a “look-back” basis (e.g., similar to Section 1260), for complicated dynamic strategies, it would be very difficult to look through the instrument to determine the consequences of a hypothetical direct investment in the underlying assets over several years.

While the administrability concerns discussed above make a look-through approach impracticable with respect to complicated underliers, it may be argued that it nonetheless should apply to simple “delta one” transactions. The possibility of this approach is discussed below in Sections VI.C and VI.D. As further discussed there, this approach may be more palatable as a practical matter, but would present a bad tax policy choice. Specifically, if a change in taxation of “delta one” prepaid forward contracts were to be warranted by any perceived concerns about accurate taxation of embedded income and gains, then non-delta-one transactions would present the same concerns. As a matter of tax policy, there would be no principled reason to distinguish between these two categories of transactions.

Assuming that a prepaid forward contract could be decomposed into its “component” parts, a long list of issues would have to be resolved before a taxpayer would know what to report on its tax return. For example, would tax-favored income such as a dividend retain its tax-favored status? would notional option premiums benefit (or suffer) from the deferral accorded real option premiums? would embedded fees and other expenses reduce the amount of income required to be taken into account, and if so, would they be treated as subject to the same kinds of limitations that could apply to those items if incurred directly? if an underlying asset were a regulated futures contract, would gain related to the replacement of that contract with a new one be treated as 60 percent long-term capital gain and 40 percent short-term capital gain? if it were an equity index option, would its deemed tax treatment depend on whether the

prepaid forward contract was listed on an exchange? if the prepaid forward contract lost value over time, would taxpayers be permitted to take current deductions for losses derived from rebalancing the referenced assets?

The overwhelming difficulty in applying any approach that relies on the deconstruction or bifurcation of financial instruments has been reflected in the fact that such attempts generally have been rejected by the traditional tax analysis of financial instruments. For example, courts have generally attempted to characterize instruments either as debt or equity, instead of attempting to separate them into components. Only a few cases have attempted to bifurcate a debt instrument into debt and equity components, and these cases effectively have been limited to their facts.¹⁰⁷

Even more telling is the history of the Treasury's failed experiments in applying bifurcation to taxation of debt instruments that provide for contingent payments. Treasury attempted to develop such an approach in drafting the proposed CPDI regulations in 1991.¹⁰⁸ The proposed regulations were widely criticized by academics and practitioners and were finally withdrawn by the Treasury as unworkable and contrary to the lines of prevalent authorities.¹⁰⁹

More fundamentally, investment in a prepaid forward contract is not equivalent to owning the underlying assets. There are, for example, real differences between owning the assets such as futures contracts or corporate shares in a managed account and having a mere contractual right to a payment under a prepaid forward

¹⁰⁷ See *Richmond, Fredricksburg & Potomac R.R. v. Commissioner*, 528 F.2d 917 (4th Cir. 1975) (dividing preferred stock into debt and equity components); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960) (dividing a shared appreciation mortgage into debt and equity components).

¹⁰⁸ See Notice of Proposed Rulemaking, Debt Instrument With Original Issue Discount; Contingent Payments, 56 *Fed. Reg.* 8308, reprinted in 1991-1 C.B. 834.

¹⁰⁹ See Notice of Proposed Rulemaking; Debt Instruments with Original Issue Discount; Contingent Payments, 59 *Fed. Reg.* 64884, 64885, reprinted in 1996-2 C.B. 84 (rejecting the previous bifurcation approach in response to the comments that “there is rarely a unique set of components into which a [CPDI] can be bifurcated” and querying “whether it is appropriate to bifurcate a [CPDI], because it is often unclear how the contingent components should be taxed.”).

contract. An important factor that is ignored by the look-through approaches is that a prepaid forward contract is a single financial instrument that has its own qualities separate from obtaining an economic exposure to the underlying assets. For example, the holder has credit risk to the issuer and that credit risk is independent of the performance of the underlying assets and is retained throughout the term of the instrument. In addition, as discussed in Section II.B, above, an investment in a prepaid forward contract is protected against risks associated with direct investments, such as tracking error.

As noted above, in addition to the complexities involved in any look-through approach, a fundamental problem with such an approach is that it puts the taxpayer in a tax position that is worse than owning the reference positions directly. Under current law, the corollary to not being required to recognize gains with respect to any rebalancing events is that a holder of prepaid forward contracts cannot deduct any losses with respect to such events. The investor also cannot actively manage its portfolio by selling its loss positions and holding its gain positions. An investor in a prepaid forward contract initially makes an investment that is governed by stated terms and, although it may not be static, is nonetheless predefined at the inception of the instrument. By investing in a prepaid forward contract, the investor is acquiring a package of risks and has no control over the components of such package. The internal rebalancing “events” therefore should not be viewed as realization events with respect to the *investor’s* investment because they occur pursuant to the original terms of the investment and they do not constitute a material change in the investor’s investment.

This is qualitatively different from, say, rebalancing of a basket of stocks at the taxpayer’s discretion. It is common knowledge that even moderately sophisticated investors time the realization of gain and losses in their investment portfolios. With careful timing management, an investor may be able to effectively eliminate or

substantially defer the recognition of any taxable gains in a stock portfolio. The same type of timing management is also employed by mutual funds that actively manage their portfolios, and even by mutual funds that merely attempt to replicate an index.¹¹⁰ An investor in a prepaid forward contract would not be able to engage in similar tax planning to minimize its tax liabilities. Subjecting the investor in a derivative instrument to the tax burdens similar to those borne by the hypothetical investor in the underlying assets without allowing a commensurate benefit would be inconsistent with the underlying premise of looking through to the referenced assets.

Some of the issues described above could be alleviated, in theory, if a look-through tax regime did not attempt to impose current taxation by reference to notional income or gains, but instead adopted a section 1260-like “look-back” recharacterization and interest charge regime. In practice, however, as described above, rules of that kind are viewed as extremely onerous. We believe that they should be limited to transactions of a kind that are considered to be motivated solely or primarily by tax avoidance. As discussed in Section II.B above, taxpayers have been investing in prepaid forward contracts for several decades primarily for non-tax reasons. The development of ETNs does not change the fact that the primary reason why investors invest in these instruments is because of the economic and practical benefits that they offer. The recent issuance of coupon-paying ETNs and one ETN that advises taxpayers that it is subject to the mark-to-market rules of section 1256 are further evidence of that point.¹¹¹

¹¹⁰ The effects of such tax management may be seen in the Vanguard S&P 500 Index Fund 2007 annual report, which states that investors were required to report *no* capital gains for 2007 by virtue of owning shares in the mutual fund, although the S&P 500 index was rebalanced in 2007, resulting in a turnover of 5.21 percent, which could be expected to produce at least some amount of capital gain. See Standard & Poor’s at http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_500/2,3,2,2,0,0,0,0,5,13,0,0,0,0,0.html) See Vanguard 500 Index Fund Annual Report (Dec. 31, 2007), *available at* <http://www.vanguard.com/funds/reports/idx500ar.pdf>.

¹¹¹ See *supra* note 37. *E.g.*, the holders of Goldman Sachs Claymore ETN are required to agree to treat the coupon payments as ordinary income despite the fact that a portion of the coupon payments

Thus, unless some type of a punitive look-back system is adopted, a look-through approach would tax prepaid forward contracts on economic income that is phantom, and impermanent. In addition, for all but the simplest “delta one” transactions, such income would be difficult to value. This is not a better system than current law. In light of these considerations, we would forcefully argue against any “look-through” or “look-back” regimes as potential models for taxation of any derivative contracts, including prepaid forward contracts.

C. Accrual of Deemed Interest.

1. Arguments advanced in favor of accrual. Several arguments have been made that accrual is an appropriate solution to the tax policy concerns raised by prepaid forward contracts.¹¹² The two main arguments for the adoption of some type of a current accrual regime for prepaid forward contracts are as follows.

would be attributable to “qualified dividend income” or long-term capital gain dividends; the holders of BearLinxSM Alerian MLP Select Index ETN are required to agree to treat as ordinary income in its entirety all monthly coupons linked to the distributions on the component MLPs, which in part would be treated as return of capital if received directly. See *also* the Morgan Stanley Market Vectors—Chinese Renminbi/USD ETNs, *supra* note 54, which provides in the tax disclosure that the ETN should be treated as a “foreign currency contract” subject to section 1256.

¹¹² For example, this topic was addressed in detail by the New York State Bar Association Tax Section in its 2001 report. See New York State Bar Association, Tax Section, “Timing and Character Rules for Prepaid Forwards and Options,” *reprinted in* 91 *Tax Notes* 815 (Apr. 30, 2001) (hereinafter, the “Report”). The Report discussed the potential benefits and drawbacks of adopting an accrual approach. Although the Report on balance recommended application of the accrual approach, it also persuasively articulated significant misgivings about the tax policy soundness and practical implications of this approach. The Report acknowledged that accrual would be more complex than the current realization based system and that taxpayers would have income before receiving any cash or property. Moreover, the Report concluded that “these extra administrative burdens arguably would not be justified for all prepaid forwards and options.” A key question posed by the Report was in which cases these costs would exceed the accuracy-related benefits of pre-realization accruals. The Report took the position that these benefits are less substantial for forwards with relatively short terms and small prepayments. The time-value return and deferral of tax with respect thereto are less significant. Accordingly, the Report acknowledged that there is a strong argument for retaining traditional accounting for instruments with sufficiently short terms, which is reinforced by the long history of realization accounting for these instruments, as well as by the Report’s informed belief that investors in “conventional” forwards generally are not driven by the availability of tax benefits. While we tend to agree with the Report’s analysis of the drawbacks of the accrual approach, we disagree with the Report’s overall conclusion that on balance the accrual approach would be an improvement over the current treatment of prepaid forward contracts as open transactions.

First, it is argued that any prepaid forward contract by virtue of the initial payment made to acquire it contains an embedded debt component. Another way of stating this argument is that prepaid forward contracts are properly deconstructed into a conventional (non-prepaid) forward contract and a bond. It is contended that because investors forego use of their money when they purchase a prepaid forward contract, they should be deemed to accrue interest as compensation for the use of that money. Under this theory, it is irrelevant whether the payout formula for the prepaid forward contract includes any references to notional dividends or other income, or whether the formula refers to assets that may change over time, because the imputed return would be a time-value-of-money return on the deemed bond.

Second, some have argued that imputation of current income should be adopted as a “second-best” regime if mark-to-market or look-through approaches are deemed unworkable. Accordingly, the proponents of this approach argue that requiring accrual of income would provide rough justice — overtaxing some investors and undertaxing others — sufficient to protect the tax system from tax-driven investments in prepaid forward contracts. Under this theory, the amount of accrual might or might not be affected by the existence of notional income or gains on referenced assets, depending on the trade-off made by the proponents between accuracy and simplicity.

2. Responses. For the reasons set forth below, we believe that it would be wrong to require investors in prepaid forward contracts to accrue income on their investments. Moreover, if accrual were to be considered as a form of rough justice (we agree that no other alternate method of accounting should be considered), then the burdens upon taxpayers resulting from creating a wholly new set of rules must be taken into account. We think that simply adding yet another set of rules to the existing complex and arcane regime for taxing financial instruments would impose a cost that outweighs whatever benefit such rules might provide. Consideration of any new rules should take place only, if at all, as part of a corresponding simplification of the law from

applying similar principles and rules to other, closely related, financial instruments that raise similar issues.

(a) Embedded debt. Requiring accrual on all prepaid forward contracts implies the view that any investment of money (in its extreme application, even common stock), regardless of the investor's objectives, expectations, and rights inherent in the instrument, contains an embedded debt element on which there is a time-value-of-money accrual. Under this view, since any investment (including common stock and options) requires an investor to forego use of its funds, the investor must expect to be compensated by a time-value-of-money return. This view diverges from current finance theory, which does not view the time value of money as a *component* of the return with respect to equity-like investments, but instead merely a useful tool and convenient *benchmark* to evaluate the minimum opportunity costs of potential investment in such equity-like instruments.¹¹³

As discussed above in Section III.A, the current U.S. tax system draws a fundamental distinction between investments that constitute debt and those that do not. Current accrual of income is required only with respect to debt instruments (*i.e.*, instruments that unconditionally guarantee a return of all or virtually all of investors' investment) or that represent an advance on a fixed stream of payments, while risky non-debt investments generally are taxed under the open transaction doctrine. That is, the tax system draws a strict line between principal-protected investments whose main risks are interest rate risk and credit risk on the one hand, and principal-at-risk investments that have much more volatile and unpredictable risks, on the other hand. Because investors in prepaid forward contracts (unlike investors in debt instruments, but similar to investors in stocks and options) have no assurance of unconditional repayment of their original investment and pursue risky returns, investments in prepaid

¹¹³ See, e.g., Moyer, McCuigan & Kretlow, *Contemporary Financial Management* at 151, 183 (5th ed. 1992).

forward contracts are not characterized as debt under general tax law principles and should not be taxed under debt-like rules. Since the accrual issues raised by prepaid forward contracts are not fundamentally different from the issues raised by other inherently risky instruments that require an upfront investment, it does not make sense to move this fundamental line in order to address prepaid forward contracts.

The corollary to the arguments made in Section IV.B.2, above, that the U.S. tax system deviates from the realization requirement only in cases where amounts serve as a substitute for interest or other fixed streams of payments is that investors in non-debt transactions do not generally take any contingent returns into income until such returns are received or become fixed. That is true of common stock.¹¹⁴ As discussed above in Section II.A, an investment in non-dividend-paying common stock economically may be recreated by purchasing a zero-coupon bond, buying a call option and writing a put option. Despite this widely-recognized equivalency, it has never been suggested that an investor holding common stock ought to be taxed on the implicit time-value-of-money amounts that could have accrued on the zero-coupon bond.

Moreover, open transaction treatment is not limited to the “physical” world. It is also true of derivative financial instruments, such as options. An investor that sells an option is not taxed on the option premium received until the option lapses or is exercised,¹¹⁵ and the buyer of the option is not required to impute any interest income notwithstanding that the pricing of options takes into account the time value of money.¹¹⁶

¹¹⁴ To illustrate this point, if an investor buys stock of Company A, which distributes its earnings annually, and stock of Company B, which reinvests all of its earnings, the investor is subject to tax on the dividends from Company A but not on the annual increase in value of Company B stock, regardless of the fact that the increase in value may be attributable to reinvested earnings. Even if Company A announces that it intends to pay quarterly dividends of \$x for the next year, the investor is not required to accrue the dividends, because Company A can change its mind at any time until a dividend is declared.

¹¹⁵ See Rev. Rul. 78-182, 1978-1 C.B. 265.

¹¹⁶ *Id.* See also Black & Scholes, “The Pricing of Options and Corporate Liabilities,” 81-3 *J. Pol. Econ.* 637-54 (May-June 1973).

While the debt/equity distinction has been rightfully criticized as producing economic distortions and requiring difficult line-drawing, it is indisputable that the distinction reflects an overall tax policy judgment that risky and non-risky investments should be treated differently. The key factor that separates risky financial instruments from less risky financial instruments is whether the investor is guaranteed to receive back its initial investment. This distinction has remained the cornerstone of the U.S. system of taxing capital investment and has not been eroded by the convergence of other economic features of various financial instruments. In the absence of a broader revision of these fundamental principles, we do not believe there is a compelling tax policy reason for moving the current dividing line between debt and non-debt.

Assuming that those principles continue to apply, we see no meaningful distinction between a prepaid forward contract and an option or other non-debt investment. As previously discussed, any interim increase in value of a prepaid forward contract may rapidly disappear because of the volatility and risky nature of the referenced assets. As a result, the tax policy concern of forcing investors to sell an investment to pay taxes on it are as valid for prepaid forward contracts as for any other investments. Moreover, prepaid forward contracts are no easier to value than single equity options that are traded on exchanges, which are not subject to mark-to-market or accrual or any other special tax regime. Requiring that investors accrue income on their investment in a particular type of financial instrument that does not guarantee a repayment of the holder's investment and whose principal risks are material non-credit/interest rate risks would represent a significant and, we think, unwarranted departure from the overall distinction between risky and non-risky investments under our current tax system. Taxing phantom income on prepaid forward contracts on the

Regulations have been proposed that would require taxpayers to accrue income with respect to contingent nonperiodic payments under swaps. Those regulations are discussed below.

basis of an embedded debt theory is no more justifiable than taxing phantom income on any other risky capital asset.

Finally, while measuring taxable income under an accrual system in theory could be less complicated than under other approaches discussed above, the economic returns that would be taxed currently still would be impermanent and illiquid.

(b) The “second-best” approach argument. Almost by definition, the arguments for adopting an accrual method of accounting for prepaid forward contracts as a second-best approach are based on pragmatism rather than tax policy. We therefore discuss several pragmatic concerns that we have with such an approach.

In addition to our general concerns about taxing phantom income, there are several other concerns with an accrual requirement. First, an accrual requirement would create a very visible distortion between synthetic and direct investments in the “easy” cases where the synthetic investment can readily be compared to investment in a single financial asset. We believe that such a development could distort investor behavior and would introduce additional frictions into the market.

This concern can best be illustrated with the example of so-called “access notes.”¹¹⁷ Access notes are a specialized type of prepaid forward contract designed to provide investors access to stocks traded in certain developing markets that are either inaccessible as a practical or regulatory matter to non-local investors, or that are available to non-local investors only in less liquid and more expensive form. Access notes attempt to replicate as closely as possible the economics of owning the underlying stock, including dividends and changes in value, subject to applicable legal requirements that do not permit complete tracking of the return on the reference stock. As an economic matter, however, investing in an access note is very similar to investing in the underlying stock.

¹¹⁷ See Annex A, Example 3.

The reasons why investors choose to acquire access notes rather than underlying stocks have absolutely nothing to do with U.S. tax considerations. Indeed, because U.S. investors cannot benefit from qualified dividend income treatment, and cannot claim foreign tax credits for withholding tax on the underlying dividends, investments in access notes would be, if anything, generally tax-disadvantaged compared to buying the referenced stock directly. If an accrual requirement were adopted for prepaid forward contracts, the treatment of an investor that purchases an access note would be even more disadvantageous, with no obvious benefit to the tax system. We do not see an easy solution to this result absent the initiation of a line-drawing exercise; it is a cost of adopting a “rough justice” rule.

Our second concern is more fundamental. If it is decided as a matter of tax policy that some form of current accrual requirement should be imposed on prepaid forward contracts, it is vital to reconcile the different accrual rules applicable to financial instruments that provide for contingent payments and to develop a single theory under which the contingencies should be taxed.

Consider, for example, the following financial instruments: (a) investor invests \$100; investor's return is \$100 plus any increase in the value of a stock index; (b) investor invests \$100; investor's return is \$100 plus or minus any increase or decrease, respectively, in the same equity index; (c) investor borrows \$100 and invests it; investor's return on the investment is \$100 plus or minus any increase or decrease, respectively, in the same equity index; investor also must repay the borrowed \$100; and (d) investor enters into an equity swap on \$100 of the equity index. These financial instruments differ from each other in various ways, but they make up a continuum of ways for an investor to obtain exposure to the equity index, with a contingent return that will be taxed at some future date. Moreover, through the alchemy of financial arbitrage, it is easy to move back and forth along this continuum by adding and subtracting options and/or leverage.

Under current law, Treasury regulations govern the tax treatment of the investor in the first instrument, which is a CPDI, under which the investor must accrue interest income on a current basis.¹¹⁸ Regulations have been proposed with respect to the fourth instrument, an equity swap, which also would require a taxpayer to accrue income on a current basis.¹¹⁹ These two sets of rules are otherwise inconsistent with each other in many important respects (see below). This is bad policy; it is bad practice; and it can confidently be expected to create new substantive, practical, and administrative problems and potentially to give rise to either loopholes or traps for the unwary. It is exactly the opposite of how Treasury should develop rules for new financial products.

Accordingly, any consideration of new rules to require accrual with respect to prepaid forward contracts should include a careful reevaluation of the decisions that have already been made for CPDIs and contingent payment NPCs. For example,

- Is it necessary for the taxpayer to make an upfront investment in order for the accrual to be required? The CPDI rules are based on the concept that a time-value-of-money return should be imputed to cash invested, while the contingent swap proposed regulations apply in the absence of any such cash investment.
- Should a risk-free rate of accrual be required or an issuer-specific rate? The proposed contingent swap regulations generally require the former, while the CPDI rules require the latter.¹²⁰

¹¹⁸ Treasury regulation section 1.1275-4(b).

¹¹⁹ See Notice of Proposed Rulemaking; Notional Principal Contracts; Contingent Nonperiodic Payments, 69 *Fed. Reg.* 8886 (Feb. 26, 2004). These proposed regulations raise many significant tax policy and practical issues, which have been addressed in two separate comments submitted by ISDA. See ISDA, Request for Clarification of Effective Date Statements in Preamble to Proposed Regulations on Notional Principal Contracts with Contingent Nonperiodic Payments (Mar. 19, 2004), *reprinted in* 2004 *Tax Notes Today* 62-34 (Mar. 31, 2004); ISDA, Comment Letter on the Proposed Regulations on Swaps With Contingent Nonperiodic Payments (Oct. 13, 2004) *available at* <http://www.isda.org>. The reference to these proposed regulations herein should not be viewed as an indication of SIFMA's agreement with the approach taken in the proposed regulations by the Treasury and IRS.

¹²⁰ The tax bill introduced by Chairman Richard Neal of the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on December 19, 2007 (H.R. 4912, or, the "Neal Bill") would introduce yet a third regime, under which investors would be required to accrue at the greater of the risk-free rate or the notional amounts credited under the contract.

- Should the accrual rate be based on rates applicable when an instrument is issued or the rates applicable when an investor buys the instrument? More generally, what rules should apply to secondary market investors? The CPDI rules nominally use the original rate, but create a *sui generis* set of rules for taking into account changes in interest rates and the expected contingent payment.¹²¹
- Should the accrual system require periodic retesting if expectations change during the term of the financial instrument? The proposed contingent swap regulations require annual retesting, while the CPDI rules do not.
- How should payments that are more than, or less than, the required accrual rate be treated? The CPDI rules have a complex set of rules for dealing with such adjustments.¹²²

Introducing an entirely new taxation scheme applicable to prepaid forward contracts without engaging in a comprehensive review of U.S. tax treatment of financial instruments related to them is likely to produce new discrepancies, inefficiencies, and opportunities for tax arbitrage.¹²³ In the absence of a uniform set of principles applicable to the tax treatment of related financial instruments providing for contingent payments, the introduction of one more separate (and likely very complicated) tax regimes to address one and only one of those financial instruments is bound to create more tax policy and practical issues than it proposes to solve. Such an additional tax regime would add to the already existing complexity that is involved not only in

¹²¹ The Neal Bill would instead use the rates applicable for the year in which an investor purchases a prepaid derivative contract, multiplied by the investor's purchase price, which would reflect any changes in expectations about the contingent payment. The Neal Bill accrual rate would be increased, however, to reflect any notionally credited amounts. The Neal Bill thus creates a novel hybrid type of accrual rate that may or may not be based on a time value of money return.

¹²² The Neal Bill would instead treat distributions in excess of the accrual rate as returns of capital. It is not entirely clear when this rule would apply, given that the accrual rate is supposed to take into account notional accruals such as dividends or interest if they exceed the risk-free rate.

¹²³ This is *not* the same as saying that a single system must be developed for taxing all financial instruments, which we acknowledge is unlikely to happen in the foreseeable future. Our recommendation is focused on the limited set of financial instruments described in the text.

Another example of the reason why we believe that a comprehensive set of rules for these instruments is important is that there is another stop on the continuum. Consider a financial instrument under which an investor invests \$60; investor's return is \$60 plus or minus any increase or decrease, respectively, in a notional investment of \$100 (not \$60) in the equity index. Is this instrument a partially prepaid forward contract? A swap with a very large upfront payment? Something else? We believe that a properly structured set of tax rules would not require a taxpayer to make distinctions of this kind because the consequences of the investment should be the same regardless of the label.

complying with the several tax schemes that have been developed to deal with other financial instruments, but also in determining, as an initial matter, which one of the many schemes applies to a particular instrument. As a result, this new system would likely result in more pressure on the tax administration and increased compliance costs for issuers and investors. Accordingly, absent a clear and consistent regime applicable to these instruments, we think the “second-best” approach to prepaid forward contracts would not represent an improvement over current law.

Finally, returning to our general principles for adopting any new tax regime applicable to prepaid forward contracts, we are also concerned about the complexity and administrability of potential tax schemes based on the current accrual of income. We strongly believe that any new rules should be understandable by investors and, as a corollary, administrable by brokers who are required to provide the necessary information to investors. We are particularly concerned that retail investors will find these rules to be complex and difficult to understand. In addition, brokers could face significant difficulties in implementing, and complying with, any new requirements that mandate accrual of current income with respect to all prepaid forward contracts.¹²⁴

Accordingly, if rules requiring accrual were adopted, for the sake of simplicity and administrability, (a) the accrual rate should be a rate that could be readily determined by retail investors (e.g., the applicable federal rate, the “AFR”), set at the inception of the instrument, and not redetermined at any time throughout the term of the instrument; (b) issuers that hedge their positions under prepaid forward contracts should be allowed to make an integration election or a hedging election; (c) reopenings should be permitted during the term of the instruments; (d) the accrued amounts should be treated as interest; (e) any returns realized in excess of the accrued amount should be

¹²⁴ In that regard we note that the information reporting rules for debt instruments have not been updated to reflect the promulgation of the final rules for CPDIs, even though those regulations have been effective since June 1996.

treated as a return of capital or capital gain and any losses should be allowed to fully offset previous accruals; (f) brokers should be permitted to report income using simplifying assumptions, including the assumption that an investor has purchased the instrument at its original issuance, as is now the case for OID; and (g) in view of the fact that the cost of deferral becomes substantial only over long periods of time, while the cost of complexity is proportionately greatest for shorter-term investments, any new rules should not apply to short- or medium-term instruments.¹²⁵ Finally, we believe that as an alternative to the accrual system, investors should be afforded an opportunity to make a mark-to-market election with respect to prepaid forward contracts.

D. Redefining Debt Generally.

Notice 2008-2 asks for comments on whether prepaid forward contracts should be treated as indebtedness pursuant to regulations issued under section 7872. Section 7872 provides potential authority for treating prepaid forward contracts as debt. The only reason to do so, however, would be to require that investors accrue current income on their investments in prepaid forward contracts. Accordingly, we believe that the discussion in Section V.C, above, addresses this question. We add here some additional thoughts specific to section 7872 and debt/non-debt distinctions generally.

First, with respect to section 7872, the existing framework under section 7872 does not provide a sensible result for prepaid forward contracts entered into by unrelated parties because its rules are principally aimed at ensuring that transactions between parties that have a pre-existing relationship are characterized in accordance with their substance. Section 7872 recasts the cash flows under an instrument into an interest-bearing loan and an offsetting payment characterized as appropriate for the relationship between the parties. For example, the time-value-of-money charges foregone on non-interest bearing loans to relatives are recharacterized as gifts, while

¹²⁵ We discuss this point further in Section VI.A, below.

the same amounts with respect to non-interest bearing loans from an employer to an employee are cast as compensation income. Since the parties entering into prepaid forward contracts are unrelated, it is difficult to explain the lack of interest payments within the categories of payments adopted by section 7872, which do not contemplate transactions where unrelated parties would forego use of their capital in a *lending* transaction without charging an appropriate time value of money therefor.

Moreover, section 7872 applies only to below-market loans, thus leaving unanswered the question of how prepaid forward contracts that provide for above-market coupons should be taxed. Finally, we do not believe that a financial instrument that provides for contingent equity- or commodity-linked returns is a “below-market” loan even if its stated return is less than the AFR. That is, the question is misdirected because prepaid forward contracts provide their return principally through risky contingent returns rather than fixed debt-like returns.

For the same reasons, we do not believe that the approach of redrawing the current debt/nondebt lines generally would be a promising resolution of the tax policy concerns that some have raised about prepaid forward contracts. The current debt/equity authorities provide that financial instruments are characterized as debt only if the investor is guaranteed a return of all or virtually all of its investment. The very limited regulatory authorities that characterize as debt certain instruments that may not unconditionally guarantee return of the holder’s entire investment still describe a very high degree of principal protection.¹²⁶ It is virtually impossible to reconsider this division only with respect to prepaid forward contracts, without affecting the more fundamental distinction of the tax treatment of debt and equity that underlies the treatment of investors under our tax system.

¹²⁶ See discussion in note 47, *supra*.

There is a high risk that any such effort would be fruitless. Congress has dealt with debt/equity issues by adopting one-off rules to address specific fact patterns.¹²⁷ A previous regulatory project undertaken to provide a single definition of debt vs. equity failed, as the Treasury and IRS encountered many difficulties in developing a single definitive set of criteria to follow in determining whether an instrument was debt or equity.¹²⁸ The Treasury and the IRS might be destined to rediscover the same truths if they again embarked on a similar quest for the debt/non-debt line.

VI. POSSIBLE WAYS TO DRAW LINES BETWEEN INSTRUMENTS.

In this Part VI, we consider four possible ways of dividing prepaid forward contracts into subcategories that might be treated differently. Some of the alternatives are based on practical considerations and suffer from a lack of theoretical justification. Others are more grounded in tax policy, but would give rise to very difficult line-drawing and implementation problems. We therefore do not recommend that any of them be adopted.

A. Long-Dated vs. Short/Medium-Dated.

Recent attention has been drawn to prepaid forward contracts in general because of the special features of ETNs, such as longer terms, active exchange trading, optional redemption for large investors, and a design targeting retail investors. The long terms of some ETNs have been criticized (incorrectly and unfairly, in our view) as allowing for up to 30 years of tax deferral on amounts notionally credited, such as dividends, interest or gains, but not currently paid or otherwise available to investors.

¹²⁷ See, e.g., section 163(e)(5) (limiting deduction available on OID on certain high yield obligations); section 279 (limiting interest deduction on indebtedness incurred by corporation to acquire stock or assets of another corporation).

¹²⁸ Treasury promulgated regulations under section 385 — which, among other issues, addressed the characterization of “hybrid” instruments — in 1982, but withdrew them in 1983. See Withdrawal of Treasury Decision 7747 Relating to Debt and Equity, 48 *Fed. Reg.* 31053 (July 6, 1983).

We believe that framing the tax policy discussion in such terms is misleading. As an economic matter, ETNs may be no less risky than prepaid forward contracts with shorter terms, so that amounts notionally credited may never be paid to investors. In addition, as discussed in Section II.C, above, the actual deferral on such instruments appears to be limited for many investors because of the high turnover of ETNs.

Although we believe it is appropriate to treat prepaid forward contracts as open transactions as long as investors' returns are not received or fixed or guaranteed, some commentators might argue that there is a potential theoretical justification for distinguishing long-dated prepaid forward contracts from relatively short-dated instruments. This justification relates to the comparative effects of inflation versus the effect of the volatility of the underlying assets on the value of the prepaid forward contract.

As a general tax policy matter, it is believed that taxing inflationary gains is undesirable because such gains do not represent real economic income. The fact that our tax system taxes all of the nominal gain on the disposition of an asset, including the component of the realized gain that is attributable purely to inflationary factors, is viewed as a practical limitation rather than a result of principled tax policy decisions.¹²⁹ Nonetheless, taxation of inflationary components of the nominal gain on the disposition of an asset is a feature of the current tax system. The real costs to taxpayers of taxing inflationary gains are more pronounced for shorter-term investments because such costs are not offset by the benefit of tax deferral. On the other hand, the real cost of taxing inflationary gains drops the further away the date on which the disposition takes place.¹³⁰ A hypothetical proponent of taxing inflationary gains might argue, however,

¹²⁹ See generally Durst, "Inflation and the Tax Code: Guidelines for Policymaking," 73 *Minn. L. Rev.* 1217 (May 1989); Shuldiner, "Indexing the Tax Code," 48 *Tax L. Rev.* 537, 540-42 (1993).

¹³⁰ See, e.g., Schenk, "A Positive Account of the Realization Rule," 57 *Tax L. Rev.* 355, 376-77 (2004) ("[R]ealization accounting has the effect of blunting the effects of inflation — the longer the period of deferral, the less the amount of the gain is attributable to inflation."); Cunningham & Schenk, "Colloquium on Capital Gains: The Case for a Capital Gains Preference," 48 *Tax L. Rev.* 319, 338

that in a tax system that as a practical matter taxes inflationary gains, it may be rational to increase the cost of that tax for long-dated instruments by imputing income on them. Moreover, over very long periods of time the effects of inflation may be a more significant component of an investor's nominal return. The hypothetical proponent of taxing inflationary gains might argue, therefore, that it would be rational to impute income on long-term instruments whose returns are more likely to reflect the effects of inflation.

To take a concrete example, compare the performance of the S&P 500 stock index in nominal dollars over two sample periods: 1973-2003 (a 30-year period) and 2000-2003 (a 3-year period). If a 30-year, non-coupon paying prepaid forward contract linked to the S&P500 index had been issued on May 1, 1973, the contract could have been expected to increase in value by more than 300 percent by May 1, 2003 solely as a result of inflation, as measured by the consumer price index. In fact, it would have increased by more than 900 percent. By contrast, if a 3-year, non-coupon paying prepaid forward contract linked to the S&P500 index had been issued on May 1, 2000, it could have been expected to increase in value by about 7 percent by May 1, 2003 as a result of inflation. Instead, however, the value of the hypothetical prepaid forward contract would have decreased by about one-third.¹³¹

(Spring 1993) ("The advantage of deferral increases over time and ultimately exceeds the disadvantage of taxing inflationary gains."); see also Isenbergh, "The End of Income Taxation," 45 *Tax L. Rev.* 283 (1990) (noting that realization requirement offsets inflation, but expressing uncertainty as to which effect predominates); McCaffery, "The Capital Gains Debate, Take Two: On Indexing and Fairness," 44 *Tax Notes* 605, 605-06 (July 31, 1989) (arguing that failure to index is not necessarily unfair because of the countervailing failure to tax accrued, but unrealized appreciation).

¹³¹ The value of the S&P 500 index as of May 1, 1973 was 104.95, and as of May 1, 2003 was 963.59. The value of the S&P 500 index as of May 1, 2000 was 1420.60, and as of May 1, 2003 was 963.59. In inflation-adjusted dollars, these numbers look different, but the trend is the same. In constant 2003 dollars, the value of the S&P 500 index as of May 1, 1973 would be 434.93; as of May 1, 2000 would be 1,517.95; and as of May 1, 2003 was 963.59. These numbers are taken from Standard & Poor's website at <http://www.standardandpoors.com>, and from consumer price index numbers derived through the Federal Reserve Bank of Minneapolis consumer price index calculator at <http://www.minneapolisfed.org/Research/data/us/calc/>.

As noted above, academics generally frown on taxing inflationary gains. The hypothetical proponent of the arguments made above thus would be arguing for rules that would exacerbate an aspect of our tax system that academics consider a problem. Moreover, any such rule would not be aligned with other term-based criteria for requiring accrual on instruments, which is usually drawn at one year.¹³² Consequently, adopting any term-based dividing line for imputing income would be somewhat arbitrary, rather than determined by application of tax policy principles. The principal merit of such a bright-line approach would be its relative clarity and simplicity. In that regard, there may be a practical reason for distinguishing long-dated prepaid forward contracts from relatively short-dated prepaid forward contracts. The cost/benefit trade-off between the complexity burden of any new rules attempting to estimate and tax future contingent income currently and the arguable benefits of such current taxation would weigh heavily against applying such new rules to instruments with relatively short maturities.

Congress in some cases has drawn a similar line at five years.¹³³ If an arbitrary line needs to be drawn, therefore, there would be at least some rationale for

¹³² See, e.g., sections 1272(a)(2)(C) (excepting obligations with term to maturity of one year or less from the scope of the OID rules); 483(c)(1)(A) (limiting applicability of rules requiring imputation of unstated interest on installment payments only to transactions where one or more payments are made more than one year after the sale); Treasury regulation section 1.446-3(e), (f) (requiring accrual of income with respect to nonperiodic payments, which are defined as any payments that are not payable at intervals of one year or less during the entire term of the contract); see also the Neal Bill (the proposed rules would not apply to contracts with term of one year or less (proposed section 1290(1)(A) or those that are held for less than one year and meet other requirements (proposed section 1289(g)(1)).

¹³³ For example, high-yield discount obligations are subject to special interest expense deferral or denial rules if they have a more than five-year maturity, on the basis that deferring the right to payment beyond that date imposes equity-like risks on investors and that the excess portion of the yield is similar to a distribution of corporate earnings on equity investments. See Section 163(i); H.R. Rep. No. 386, 101st Cong., 1st Sess. 46 (1989). That Congress drew the line at five years in the context of rules for high-yield discount obligations is especially relevant because a current tax deduction to an issuer of a note with respect to an uncertain future cash outlay economically corresponds to a deferral of income inclusion with respect to a potential future cash inflow.

For other examples of provisions where Congress has drawn the line at five years, see Section 1202(a)(1), (b)(2) (providing beneficial treatment for non-corporate taxpayers owning qualified small business stock for more than 5 years on the rationale that such a holding period exposes the owners to

picking a five-year line, meaning instruments with a maturity of more than five-years when issued. A five-year bright-line test also would be consistent with our recommendation in Section V.C above, that if accrual rules for prepaid forward contracts are adopted on a “second-best” theory, that they should apply only to longer-dated contracts.

B. Exchange-Traded vs. OTC Instruments.

As discussed above in Section II.C, another distinguishing feature of ETNs is the fact that they can be readily valued since they are listed on an exchange. One might therefore consider writing rules that distinguish between ETNs and perhaps other exchange-listed prepaid forward contracts, on the one hand and OTC prepaid forward contracts, on the other. The natural rule to impose would be a mark-to-market rule, as the ease of valuing ETNs is the only policy-based reason for distinguishing between ETNs and OTC contracts.

The policy issues associated with applying a mark-to-market regime to ETNs are grounded in the realization requirement discussed in Section IV.A, above. For the reasons discussed in that section (other than valuation), we do not believe prepaid forward contracts, including ETNs, are appropriate candidates for a mark-to-market system. Moreover, to the extent that tax policymakers are concerned about notional crediting of income or embedded gains, it should make no difference whether or not a prepaid forward contract is traded on an exchange. Finally, it seems to us perverse to impose a system wholly unfamiliar to typical retail investors on precisely the

significant levels of risk); and former section 1(h)(2) (providing a lower capital gains tax rate for capital assets held more than 5 years, subject to certain exceptions).

We also note that the New York State Bar Association Tax Section Report on NPCs recommended a three-year cut-off for NPCs, because of similar concerns about the trade-off between accuracy and complexity. See New York State Bar Association Tax Section, “Report Responding to Notice 2001-44 on the Timing of Income and Loss From Swaps Providing for Contingent Payments,” *reprinted in 2001 Tax Notes Today* 221-39 (Nov. 14, 2001).

subcategory of prepaid forward contracts most likely to be purchased by such investors.¹³⁴

C. Total Return Economics vs. Price Return.

The tax policy concerns with ETNs are most frequently described as concerns relating to the deferral or disappearance of notional income or gains from reference assets. We consider, therefore, the possibility of drawing the line between “total return” prepaid forward contracts, on the one hand, and “price only return” prepaid forward contracts, on the other. A similar dividing line might be considered between contracts where the referenced assets may change over time and contracts where the composition of the referenced assets is fixed throughout the term of the contract. Compare, for example, the terms of the instrument described in Annex A, Examples 1 and 2 (linked to the Nikkei 225 index and to the CBOE Buy-Write index), on the one hand, with those described in Annex A, Examples 3 and 4 (linked in each case to a single stock), on the other hand.

We do not think an approach of this kind would be an improvement over current law. Drawing lines of this kind does not answer the question of how prepaid forward contracts on the “wrong” side of the line should be taxed. Part V discusses the available alternatives, and our conclusions there that the best course is not to change current law would be equally applicable here.

As a practical matter, if a decision were made to subject “total return” prepaid forward contracts to a new timing regime, small differences in the structuring of a contract could put it on one side or another of the line, with results that would be hard to justify. Questions might also be raised about which side of the line a prepaid forward

¹³⁴ The Treasury testimony on the Neal bill indicates that investment in ETNs by retail investors is a driving force behind the government’s consideration of whether accrual should be required on prepaid forward contracts, because of the larger number of investors and their lesser sophistication about tax matters. See the Treasury Testimony, *supra* note 3, at 10.

contract that provides for notional reinvestments of dividends should fall, if the reference stock in fact pays no dividends but might start to do so during the term of the contract.

As a theoretical matter, the fact that a contract is a price return-only contract does not mean that dividends or other distributions on reference assets play no role in the overall economics of the contract. For example, in Annex A, Example 1, the terms of the prepaid forward contract provide that the investor is entitled to a multiple of any increase in the referenced equity index, up to a cap. The leverage implied by the right to receive a multiple of increases in the index is “paid for” in part by the cap — that is, as compared to a direct investment in the index stocks, the investor is giving up the right to appreciation above the cap — and in part by dividends on the index stocks that the investor foregoes as compared to a direct investment in the index stocks. It is inherent in the distinction between a total return and a price return-only contract that this very indirect and wholly contingent (because the index may go down rather than up) benefit from dividends on the equity index does not cause the contract to fall on the “wrong” side of the line. That is reasonable as it is difficult to see what tax policy is being violated here by applying the open transaction doctrine. But it is not difficult to imagine transaction structures where the benefit of dividends or other distributions on the referenced assets would be more direct or less contingent, without an express reference to such distributions in the terms of the contract. We do not think inviting taxpayers to engage in structuring exercises of this kind furthers the interest of either taxpayers or the government.

D. Degree of Riskiness of Underlying Assets.

Another possible way to divide prepaid forward contracts into subcategories could be based on the inherent riskiness of the assets underlying the prepaid forward contract. For example, a derivative linked to the performance of assets such as debt or currencies may be viewed as having a fundamentally different risk profile than a prepaid forward contract linked to risky assets such as equities or

commodities. Under this approach, if the returns on a prepaid forward contract were linked to some type of investments generally considered “debt-like,” such as cash, debt obligations or currencies, that contract would be subject to some new timing regime while prepaid forward contracts linked to risky equities or commodities would not. In effect, this approach would drastically expand the position taken in Revenue Ruling 2008-1 to apply more broadly to debt-like risks and returns.

Drawing the line based on this criterion would be more satisfactory as a matter of tax policy than the other proposals discussed above, because this type of distinction would be more in line with the existing principles of taxing investments in accordance with their risk/reward profiles. In addition, the specific approach could be developed along the lines that have already been drawn in section 988 (*i.e.*, cash/currency/bonds vs. equities/commodities). This system therefore would fit relatively well into the existing framework as a conceptual matter.

This approach, however, would have a significant drawback in that it probably would be the least practical and the most difficult to administer out of the four line-drawing approaches. For the reasons discussed in Section II.B, above, many prepaid forward contracts represent a combination of exposures to assets with different risk profiles. Investors frequently view structured notes as an opportunity to obtain diversified exposures to a variety of risks in a single wrapper. It would be difficult to decide how to characterize particular instruments that combine exposures to both debt-like and non-debt-like returns. Consequently, although this alternative appears to be the most attractive of those described in this Part VI as a theoretical matter, we believe that no attempt should be made to develop rules on this basis.

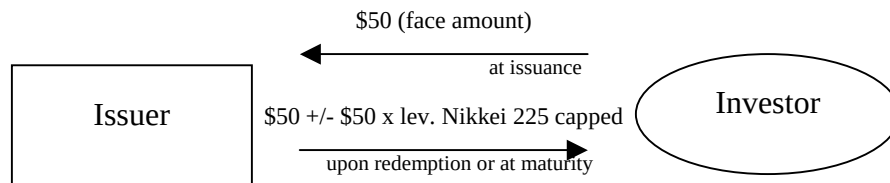
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In conclusion, it is our view that, as a tax policy matter, there is no better alternative to current law governing prepaid forward contracts, regardless of whether any new set of rules were to apply to all prepaid forward contracts or only to a subset.

As discussed above, all of the suggested alternatives would violate some or all of the tax policy concerns about the impermanence, illiquidity, and difficulty of measurement of returns to be taxed that underlie the realization principle that is the fundamental timing rule of the Code. Furthermore, each of the solutions that has been or could be proposed to address perceived problems under current law has significant drawbacks and some have almost insurmountable complexities. None of the proposed alternative methods to current treatment of prepaid forward contracts would meet all of the tax policy principles of clarity, consistency, administrability, and balance that we believe should guide any new tax rules. Accordingly, we do not recommend that any of them be adopted.

Annex A – Examples of Structured Products Treated as Non-Debt Transactions

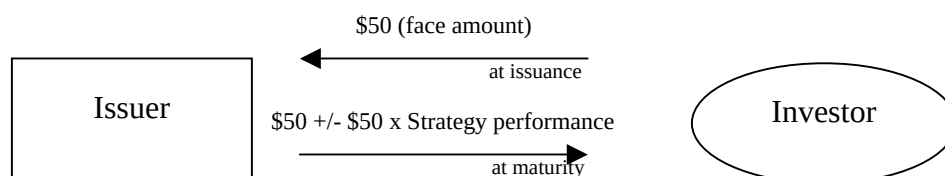
1. Leveraged Capped Notes Linked to the Nikkei 225 Index (Non-Coupon-Paying)



- 1.5-year term to maturity.
- Linked to the performance of the Nikkei 225 Stock Average. The Nikkei 225 is a price return index, which means it does not reflect the value of any dividends paid on the component shares included in the index.
- No current coupons paid.
- At maturity of the note:
 - o If the Nikkei 225 has lost value since the issuance of the note, the investor receives a cash amount equal to the face amount of the note less the face amount of the note multiplied by the percentage change in the value of the Nikkei 225.
 - o If the Nikkei 225 has appreciated in value since the issuance of the note, the investor receives a cash amount equal to the face amount of the note plus the face amount of the note multiplied by 3 times the percentage change in the value of the Nikkei 225, subject to a maximum return of 27 percent (which means the investor cannot receive more than \$63.50 per note).
- The note does not offer any principal protection — an investor may lose all of its investment if the Nikkei 225 declines to zero.
- These notes also may be offered with a “buffer” that would provide an investor with a limited principal protection. For example, for a note offered with a 10-percent buffer, if the Nikkei 225 declines in value by less than 10 percent since the issuance of the note, the investor would not lose any of its investment and would receive a cash amount equal to the face amount of the note. If the Nikkei 225 declines by more than 10 percent, the investor would receive a cash amount equal to the face amount less the face amount multiplied by the percentage decrease in the value of the Nikkei 225 *in excess* of 10 percent (e.g., if the Nikkei 225 declined by 20 percent, the investor would receive \$45; if the Nikkei 225 declined by 95 percent, the investor would receive \$7.50).

- The issuer may hedge the notes by holding a portfolio of stocks replicating the Nikkei 225 and buying and selling put and call options corresponding to those embedded in the note. Any variations between the performance of such portfolio and the payout on the notes would be for the benefit or loss of the issuer.

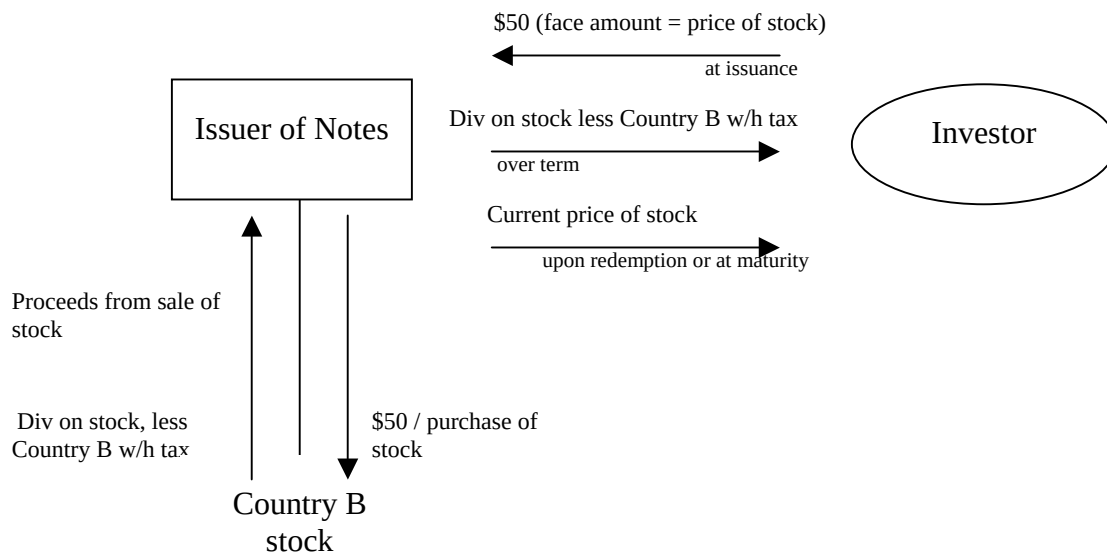
2. Notes Linked to a Covered Call Strategy (Non-Coupon-Paying)



- 5-year term to maturity.
- Linked to the performance of Chicago Board of Exchange BuyWrite Index (CBOE BXD), which tracks the performance of a hypothetical at-the-money covered call strategy on the Dow Jones Industrial Average (DJIA) index.
 - o The BXD Index represents an at-the-money covered call strategy in which an investor holds a hypothetical investment in a stock portfolio comprised of the stocks included in the DJIA index and sells hypothetical options on the DJIA index (DJX), traded on CBOE.
 - o The hypothetical DJX call options are sold monthly, with a term of one month (*i.e.*, the options “roll” monthly).
 - o The hypothetical DJX calls are written with strike prices that are equal to, or slightly greater than, the level of DJIA when the options are sold. Their strike prices and premiums are determined by reference to the actual DJX call options traded on CBOE.
 - o The notional amount invested in the DJIA stock portfolio is increased to reflect the notional dividends on each stock underlying DJIA on the ex-dividend date for each dividend and the hypothetical option premium on the day each DJX call is notionally written. That is, notional dividends and notional option premiums are reinvested in, and cannot be severed from, the BXD index or the note.
- No current coupon paid.
- At maturity of the note, an investor receives a cash amount equal to the face amount of the note plus (if positive) or minus (if negative) the face amount multiplied by the percentage change in the BXD index since issuance of the note. The note does not offer any principal protection — an investor may lose all of its investment if the BXD index declines to zero.
- Issuers may offer similar notes that are linked to other complex strategies, such as long/short equity strategies or other strategies where the composition of the underlying varies according to a preset formula.
- The issuer may hedge the notes by holding a portfolio of stocks replicating the DJIA index and selling the DJX call options. Any variations between the

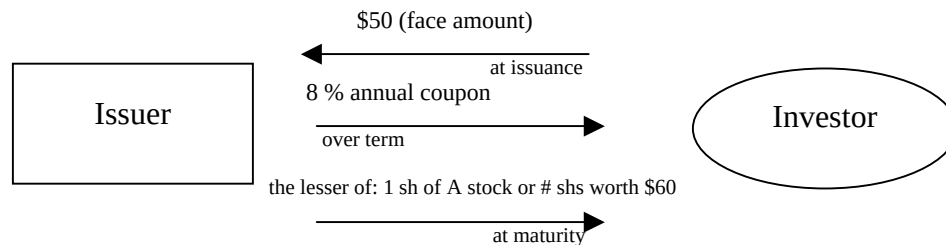
performance of such portfolio and the payout on the notes would be for the benefit or loss of the issuer.

3. Access Notes (Single Stock, Coupon-Paying)



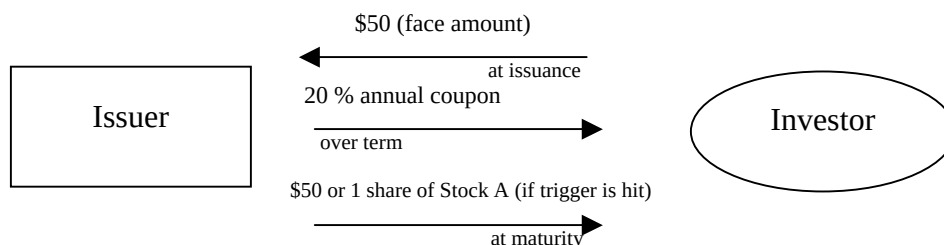
- 3-year term to maturity.
- The note is designed to provide investors with an access to Country B equity markets, which may impose burdensome restrictions or excessive costs on direct non-Country B investors. Accordingly, the note is intended to mimic the economic performance of a single stock of a Country B corporation.
- On issue date, the investor pays the amount equal to the then-current trading price of Country B stock. Over the term of the note, the investor substantially contemporaneously receives cash distributions equal to the amount of dividends paid on Country B stock, less Country B withholding tax that would be imposed on a hypothetical foreign investor with standardized tax attributes.
 - o Investors typically agree to treat current distributions as ordinary income not eligible for qualified dividend income treatment and that does not bring foreign tax credits with them.
- At maturity of the note, the investor receives an amount of cash equal to the trading price of Country B stock on the maturity date, which may be determined based on the volume-weighted average price for the stock in that day.
- Like a direct investment in the referenced Country B stock, the note does not offer any principal protection — the investor may lose all of its investment in the notes if the value of the Country B stock declines to zero.

4. Capped Exchangeable Notes (Coupon-Paying)



- 1.5-year term to maturity.
- Linked to the performance of a single stock (Company A).
- At maturity, per each note:
 - o If Company A stock trades at or below the cap of \$60 per share (120 percent of the price of Company A stock at the issuance of the note), the investor receives one share of Company A stock (or cash equivalent).
 - o If Company A stock trades above the cap of \$60 per share, the investor receives the number of shares of Company A stock worth \$60 or \$60 in cash (similar to selling a call option on stock with a strike price equal to \$60).
- Pays annual coupon at a fixed rate of 8 percent, which economically reflects dividends and option premium.
 - o By purchasing the notes, investors typically agree with the issuer to report the coupons on a current basis as ordinary income.
- The note does not offer any principal protection. An investor has 100 percent downside exposure and may lose all of its investment in the note if the value of Company A stock declines to zero. The investor benefits from the high coupon and may benefit from the appreciation value of Company A stock up to 20 percent.
- The issuer may hedge the notes by holding Company A stock and selling a call option corresponding to that embedded in the note. Any variations between the performance of the combination of the stock and call option and the payout on the notes would be for the benefit or loss of the issuer.

5. Reverse Convertible Notes



- 1.5-year term to maturity.
- Linked to the performance of a single stock (Company A).
- At maturity, per each note:
 - o If *at any time* during the term of the note, Company A stock traded at or below \$35 (which is 70 percent of the price of Company A stock at the issuance of the note), the investor receives one share of Company A stock (or cash equivalent); *otherwise*
 - o The investor receives \$50 back.
- Pays annual coupon at a fixed rate of 20 percent, which economically reflects option premium on the knock-in option with respect to Company A stock.
 - o The offering document describes the coupon as consisting of the interest paid to the investor at the rate approximately equal to the issuer's comparable yield and the option premium.
 - o By purchasing the notes, investors typically agree with the issuer to report the interest component of the coupons on a current basis as ordinary income.
- An investor has 100 percent downside exposure if the value of Company A stock declines to 70 percent of its value at the inception of the note at any time during the term of the note. If the value of Company A stock declines to zero, the investor may lose all of its investment in the note.
- Generally, the positive returns paid on the note are derived from the very high coupons and the investor does not benefit from the appreciation of the stock, unless the downside trigger is hit. If the downside trigger is not hit, the investor receives back its upfront payment.