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Tax Planning Strategies for Derivative Financial Products

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Overview

I. Determining the Tax Treatment of New Financial Products

A. Existing Rules for Traditional Derivatives (Options, Forwards, Futures, and Swaps)

B. Market Practice or "Cubbyhole" Approach for New Financial Products

C. Unexpected or Disparate Tax Consequences

II. Variable Prepaid Forward Contracts

I. Determining the Tax Treatment of New Financial Products

A. Existing Rules for Traditional Derivatives: Fundamental Tax Issues

1. What is the general rule for determining the timing of income recognition with respect to economic returns from the instrument?
2. What is the general rule for determining the character of the income generated by the instrument (*e.g.*, capital gain vs. ordinary income, tax-exempt vs. taxable income)?
3. What is the general rule for determining the source (U.S. or non-U.S.) of the income generated by the instrument?

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Options

1. Definition -- An option is generally defined as a unilateral contract that gives the holder of the option the right, but not the obligation, to buy from or sell to the counterparty specified property at a fixed price at a specified time (a "European-style option") or at any time during a specific period of time (an "American-style option").

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Options (cont'd)

2. Timing

a. Gain or loss from options generally is recognized on a "wait-and-see" (open transaction) basis.

b. The option premium paid or received is taken into account, and gain or loss is recognized, when the option is sold, lapses unexercised, or is settled for cash.

c. If an option is settled by physical delivery of the underlying property:

(i) the taxpayer selling the property recognizes gain or loss based on the difference between the amount received (adjusted by the amount of any option premium paid or received by the taxpayer) and the taxpayer's basis in the property; and

(ii) the taxpayer purchasing the property treats the contract price (adjusted by any option premium paid or received by the taxpayer) as the basis for the property acquired and recognizes gain or loss when such property is sold or exchanged.

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Options (cont'd)

3. Character

a. Gain or loss attributable to the cash settlement of, sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property, generally is considered to have the same character as the property to which the option relates. Sections 1234(a) and (c).

b. In the case of grantors of options in stock, securities, or commodities, gain or loss from any closing transaction with respect to, and gain on lapse of, an option in property is treated as short-term capital gain or loss. Section 1234(b).

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Options (cont'd)

4. Source

a. Non-U.S. persons typically recognize non-U.S.-source gain or loss from the exercise, sale or cash settlement of an option. Section 865(a).

b. U.S. persons (including resident alien individuals) generally recognize U.S.-source gain or loss from the exercise, sale or cash settlement of an option. Section 865(a).

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Forwards

1. Definition -- A forward contract is a bilateral executory contract pursuant to which the forward buyer agrees to purchase, and the forward seller agrees to sell, a fixed quantity of property at a fixed price (the "forward price"), with payment and delivery occurring on a fixed future date (the "delivery date").

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Forwards (cont'd)

2. Timing

a. Gain or loss equal to the amount received or paid is recognized when a forward contract is sold or settled in cash.

b. If a forward contract is settled by physical delivery of the underlying property:

(i) the taxpayer selling the property recognizes gain or loss based on the difference between the amount received and the taxpayer's basis in the property; and

(ii) the taxpayer purchasing the property treats the contract price as the basis for the property acquired and recognizes gain or loss when such property is sold or exchanged.

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Forwards (cont'd)

3. Character -- The character of the gain or loss from a forward contract is generally the same as the character of the property delivered.
   a. If a forward contract is settled by cash payment, the gain or loss is capital if the underlying property is capital. Section 1234A.
   b. If a forward contract is sold, the gain or loss is capital if the forward contract is a capital asset in the hands of the selling taxpayer, without regard to the character of the underlying property. Section 1221.

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Forwards (cont'd)

4. Source

a. U.S. persons (including resident alien individuals) generally recognize U.S.-source gain or loss from the sale or settlement of a forward. Section 865(a).

b. Non-U.S. persons typically recognize non-U.S.-source gain or loss from the sale or settlement of a forward. Section 865(a).

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Futures

1. Definition -- A futures contract is a forward contract that is standardized and traded on an organized futures exchange, such as the Chicago Mercantile Exchange.
   a. The exchange acts as the counterparty to every transaction.
   b. Every trade on the futures exchange effectively results in two contracts: one between the forward buyer and the exchange; and the other between the forward seller and the exchange.

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Futures (cont'd)

2. Timing -- Futures contracts that are traded on domestic (and some foreign) futures exchanges are generally treated as section 1256 contracts, and gains and losses are recognized on an annual "mark to market" basis.

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Futures (cont'd)

3. Character -- Gain or loss from the settlement of futures contracts that are section 1256 contracts is treated as 60-percent long-term capital gain or loss and 40-percent short-term capital gain or loss.

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Futures (cont'd)

4. Source

a. U.S. persons (including resident alien individuals) generally recognize U.S.-source gain or loss from the settlement of a futures contract. Section 865(a).

b. Non-U.S. persons typically recognize non-U.S.-source gain or loss from the settlement of a futures contract. Section 865(a).

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Swaps

1. Definitions

a. A swap is an agreement between two parties to exchange specified sets of cash flows over a period of time.

b. A swap that provides for periodic payments determined by reference to a specified objective index is a "notional principal contract" ("NPC").

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Swaps (cont'd)

2. Timing

a. The parties to an NPC must classify all payments pursuant to the contract as either: (i) a "periodic" payment; (ii) a "non-periodic" payment; or (iii) a "termination" payment. Reg. § 1.446-3.

b. In general, taxpayers must recognize (as income or deduction, as applicable) the ratable daily portions of all "periodic" and "non-periodic" payments for the taxable year to which that payments relates, and a "termination" payment in the year the NPC is extinguished, assigned, or terminated. Reg. § 1.446-3.

c. Under Prop. Reg. § 1.446-3, contingent non-periodic payments are accrued over the term of the NPC based on an estimate of the amount of the payment. The amount of a taxpayer's accruals is periodically redetermined as more information about the expected amount of the non-contingent payment becomes available.

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Swaps (cont'd)

3. Character

a. Prop. Reg. § 1.1234A-1 would provide that any payment under an NPC other than a termination payment (*i.e.*, a periodic or non-periodic payment) generally constitutes ordinary income or expense.

b. Prop. Reg. § 1.1234A-1 would provide that gain or loss attributable to the termination of an NPC should be capital if the contract is a capital asset in the hands of the taxpayer.

I. Determining the Tax Treatment of New Financial Products (cont'd)

A. Existing Rules for Traditional Derivatives: Swaps (cont'd)

4. Source -- In general, income from an NPC is sourced by reference to the residence of the taxpayer, with the exception of income earned through a U.S. branch, which is treated as U.S.-source income. Reg. § 1.863-7.

I. Determining the Tax Treatment of New Financial Products (cont'd)

B. Market Practice or "Cubbyhole" Approach for New Financial Products

1. The tax system generally looks to case law to define the standards to be used to distinguish between corporate debt and equity and sets forth rules that have been developed for options, forward contracts, futures and swaps.
2. When faced with a new financial product, taxpayers must assess all of the terms of the product and decide which existing cubbyhole is most analogous to the new product.
3. In the absence of IRS guidance, tax professionals generally follow market practice in assigning the product to a cubbyhole.

I. Determining the Tax Treatment of New Financial Products (cont'd)

C. Unexpected or Disparate Tax Consequences

Because one derivative can be, and often is, used to achieve economic returns that are indistinguishable from another derivative in an underlying physical security, the use of the "cubbyhole" approach can lead to disparate tax treatment of two instruments that have economically similar returns.

II. Variable Prepaid Forward Contracts

A. Introduction

1. The determination of whether a taxpayer has sold property for federal income tax purposes depends on whether the benefits and burdens of ownership have passed from the taxpayer to the transferee.
2. Courts have considered various factors in determining whether the benefits and burdens of ownership have shifted, including: (a) whether the sale price was fixed; (b) whether a significant amount of the sale price was paid; (c) which party bore the risk of loss and opportunity for gain; (d) whether legal title had passed; and (e) whether the right to possession had passed.

II. Variable Prepaid Forward Contracts (cont'd)

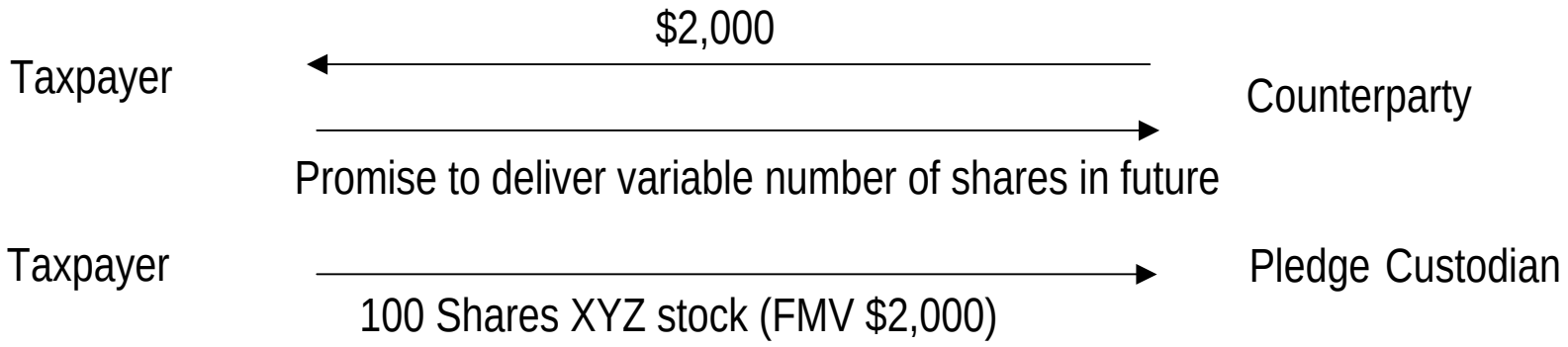
A. Introduction (cont'd)

3. Section 1259(c)(1)(C) provides that a taxpayer is treated as having made a "constructive sale" of an appreciated financial position if the taxpayer enters into a futures or forward contract to deliver the same or substantially identical property.
4. Section 1259(d)(1) defines a "forward contract" to mean a contract to deliver a "substantially fixed" amount of property for a "substantially fixed" price.

II. Variable Prepaid Forward Contracts (cont'd)

B. Example

Execution Date: March 9, 2006



1. The taxpayer enters into a contract with a counterparty with respect to appreciated stock owned by the taxpayer.
2. The counterparty makes an upfront payment to the taxpayer in exchange for the taxpayer's promise to deliver a variable number of shares of stock on a specified future date.

II. Variable Prepaid Forward Contracts (cont'd)

B. Example (cont'd)

3. The number of shares to be delivered by the taxpayer depends on the price of the stock on the future exchange date. As a result of the formula for determining the number of shares to be delivered, the taxpayer may retain little if any risk of loss with respect to the stock and a limited opportunity for gain from appreciation of the stock.
4. To secure its obligation to deliver the shares of stock (or the cash equivalent), the taxpayer pledges to the counterparty the maximum number of shares that are deliverable under the contract.
   a. The pledged shares may be held by a third party custodian or directly by the counterparty or an affiliate of the counterparty.
   b. The taxpayer may have the right to substitute other shares of the same stock, cash, or government securities as collateral.

II. Variable Prepaid Forward Contracts (cont'd)

B. Example (cont'd)

5. The counterparty is likely to hedge its risk under the contract by selling short shares of the same stock.
6. The cost of the transaction to the taxpayer reflects the counterparty's expected cost of hedging its risk.

II. Variable Prepaid Forward Contracts (cont'd)

C. Rev. Rul. 2003-7

1. The IRS ruled that a taxpayer that entered into the variable prepaid forward contract described in the Ruling had not sold its shares of stock under common law principles nor made a constructive sale of the shares under section 1259.
2. Key factors
   a. The taxpayer had the right to settle the contract in cash and was not "economically compelled" to settle the contract with shares of stock;
   b. The taxpayer retained the right to dividends on the pledged shares and the right to vote the pledged shares;
   c. The pledged shares were held by a third-party trustee;
   d. The number of shares that were deliverable under the contract, which could vary by 25 percent, were subject to "significant variation."

II. Variable Prepaid Forward Contracts (cont'd)

D. TAM 200604033

Does a Stock Loan Convert a Variable Prepaid Forward Contract Into a Sale?

Execution Date

A. Taxpayer ← $2,000 — Counterparty

B. Taxpayer → 100 Shares XYZ stock (FMV $2,000) — Trustee (Pledge of Shares)

C. Trustee → 100 Shares XYZ stock (FMV $2,000) — Counterparty (Stock Loan)

II. Variable Prepaid Forward Contracts (cont'd)

D. TAM 200604033 (cont'd)

1. The IRS ruled that the taxpayer had made a taxable disposition of stock when it entered into a variable prepaid forward contract, pledged shares of stock to the counterparty bank, and permitted the bank to borrow the pledged shares to sell short.
2. The IRS distinguished Rev. Rul. 2003-7 on the grounds that the bank acquired possession and unfettered use of the pledged stock on the agreement closing date. According to the IRS, Rev. Rul. 2003-7 did not envision delivery of the pledged shares to the counterparty on the closing date of the agreement and was not applicable to the transaction.
3. Under common law principles, the combined transactions constituted a sale of the stock to the counterparty.
4. Is TAM 20604033 correct?

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