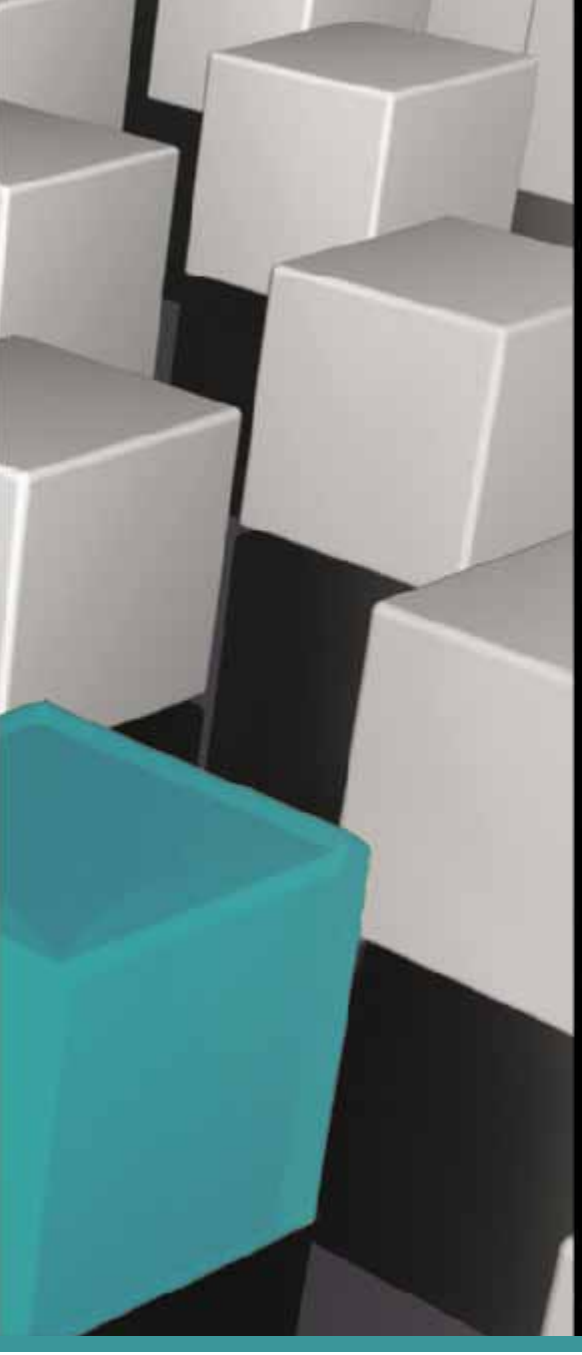

Prepaid Forward Contracts

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Introduction

- A prepaid forward is a contract in which one party agrees to purchase an asset on a future date for a specified price.
  - Differs from a traditional forward contract because the purchase price is paid in advance of future delivery or cash settlement.
  - Can be settled in cash or physically, but in financial markets, cash settlement is more common.
- Some prepaid forward contracts have periodic payments.
- Some prepaid forward contracts are publicly traded (“ETNs”).

Assets Tracked

- Prepaid forward contracts may track many different types of assets:
  - Single stock
  - Broad, well-known equity index;
  - Narrower, less well-known equity index;
  - Commodities;
  - Commodity indexes;
  - Currencies;
  - Debt instruments;
  - Indices composed of debt instruments;
  - Real estate indices;
  - Interest rate indices.

History of Prepaid Forwards

- Prepaid forward contract first publicly identified as such in 1993.
- Became common in structured finance markets in the mid-1990s.
- Appeared in over-the-counter markets in the late 1990s—early 2000s.
- First exchange traded prepaid forward contracts appeared in mid-2000s.

Overview of Tax Analysis

- When do we have a prepaid forward contract?
- What if we do have a prepaid forward contract?
  - Deemed ownership of underlying asset?
  - Accrual of interest on prepaid forward contract?
  - When are gains and losses recognized?
  - What is the character of those gains and losses?
  - How are periodic payments treated?

Tax Classification – Part I

- Critical to the conclusion that a prepaid forward contract exists:
  - Asset must be fungible and relatively easily traded *or*
  - Buyer must not have current rights in the underlying asset.
  - Buyer must not have (complete) principal protection.
  - Other factors (discussed later).
- What follows from conclusion that parties have entered into a prepaid forward contract?

Tax Classification – Part I

- If an instrument purports to be a prepaid forward contract, what else could it be?
  - a debt instrument (e.g. if principal guaranteed in any currency);
  - current ownership (if a single illiquid asset)
  - a managed account (esp. if index under the control of the buyer);
  - a notional principal contract (only possible if provides for cash settlement and periodic payments);
  - an interest in an entity (if issuer is a special purpose vehicle; this would be rare);
  - an option (e.g., if exposure to the underlying is not the substantial economic equivalent of ownership)

Tax Classification – Part II

- Buyer has not purchased, and seller has not sold, the underlying property. (But see anti-avoidance rules)
- Buyer does not accrue income, nor seller take deductions, during life of contract.
  - A prepaid forward is (generally) not a debt instrument. *But see* Rev. Rul. 2008-1 (discussed later).
  - Section 7872 legislative history unclear, but current regulations do not appear to require accrual of interest income on prepaid forward contracts.

Tax Classification – Part II

- Recognition of gains or losses
  - Sale, exchange or settlement:
    - Gains generally capital.
    - Source of income determined under rules for dispositions of property.
  - Change in index
    - No gain or loss recognized, if change happens pursuant to terms of contract.
    - Many gray areas here.
- Periodic payments – uncertainty as to timing, character, and source.

The Government Starts Paying Attention

- IRS Revenue Ruling 2008-1
- Notice 2008-2
- The Neal Bill

Revenue Ruling 2008-1

- Instrument was cast in the form of a prepaid forward contract
- Provided that the holder would purchase the instrument for the U.S. dollar value of a set number of euros.
- At maturity, the holder was entitled to the initial number of euros plus the relevant euro-based interest rate, minus a fee, all converted back into dollars based on the then-current EUR/USD exchange rate.

Revenue Ruling 2008-1 (continued)

- Treasury held that the instrument was euro-denominated indebtedness of the issuer.
- Result is not affected if the Instrument is (i) privately offered, (ii) publicly offered, or (iii) traded on an exchange.
- Query: would this result have been the same absent Section 988?

The Request for Comments

- At about the same time as Treasury issued Rev. Rul. 2008-1, it also issued Notice 2008-2, requesting comments.
  - Request for comments seemed to focus on desirability of requiring accrual of income to buyer.
  - Many groups submitted comments, which went different directions.
    - Mutual fund industry does not like ETNs.
    - Investment banks generally do like them.
    - Some are in both camps.

The Neal Bill

- In December 2007, Rep. Neal introduced H.R. 4912, which generally would have required accrual of interest on a prepaid forward contract. Bill was complicated:
  - Inclusion required at the short-term AFR or actual amounts credited, whichever was greater.
  - Losses at maturity were ordinary, to the extent of ordinary income. Cf. Treas. Reg. § 1.1275-4(b)(6)(iii)(B).
  - Inclusion could be capped, in case of publicly traded instrument, by fmv of instrument.
- No provision for seller, perhaps on theory that the seller will always be on mark-to-market.

The Future of Prepaid Forward Contracts

- Recent market events have changed the landscape significantly
  - buyers unwilling to accept seller credit risk.
  - lack of enthusiasm for new products, esp. commodities and energy.
- Tax policy landscape changed, too.
  - Requiring accrual of income less justifiable desirable as a policy matter when asset markets plunge.
  - Mark-to-market seen as less reliable measure of income when liquidity dries up.