November 19, 2008

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Notice 2008-2

Dear Commissioner Shulman:

Enclosed are comments concerning Notice 2008-2. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William J. Wilkins
Chair, Section of Taxation

Enclosure

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service
    Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal drafting responsibility for preparing these Comments was exercised by Matthew A. Stevens in close consultation with Lucy W. Farr and Mark H. Price of the Section’s Financial Transactions Committee (the “Committee”). Substantial contributions were made by Linda Carlisle, David Garlock, and Richard Larkins. The Comments were reviewed by George C. Howell, III, of the Section’s Committee on Government Submissions, and by C. Wells Hall, the Section’s Council Director for the Committee.

Although members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Matthew A. Stevens
(202) 756-3553
matthew.stevens@alston.com

Date: November 19, 2008
EXECUTIVE SUMMARY

In Notice 2008-2, 1 (the “Notice”), the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) requested comments regarding various aspects of the treatment of prepaid forward contracts. Many different factors must be taken into account in determining the proper regime for taxing prepaid forward contracts. In particular, one must consider the government’s authority to adopt the particular regulatory regime being considered, whether such regime will accurately reflect the income of the parties to the contract, whether such regime is administrable, whether it results in similar treatment for comparable investments, and whether it departs in a material way from well-established common law rules. Applying these theories to a number of different regimes, we conclude that a regime requiring the accrual of income at a rate of return based on debt yields (an “accrual regime”) likely is within the authority of the government to adopt, but that it does not necessarily accurately reflect the income of the parties. In addition, there are significant issues involved with the scope of an accrual regime. We also considered a regime based on section 1260, but this regime would not be broad enough to cover a variety of common contracts and would not necessarily accurately reflect the incomes of the parties. 2 In addition, it would not apply to sellers at all, thus casting doubt on the fairness of the regime. Finally, we considered both a look-through realization regime and a mark-to-market regime, but concluded that, on balance, neither was preferable to the existing realization-based method of accounting. We also provide some comments regarding ancillary issues involving prepaid forward contracts, including the treatment of prepaid forward contracts that provide for periodic payments and the treatment of such contracts in the international arena.

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2 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
DISCUSSION

I. Background

The Notice describes prepaid forward transactions as follows:

These transactions resemble typical forward contracts (that is, bilateral, executory contracts in which one party agrees to purchase an asset on a future date for a specific forward purchase price, payable at that future time), but the purchase price is paid in advance of future delivery or cash settlement. Thus, these transactions 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.

Typically, the contract does not provide for any interim payments prior to settlement, although contrary examples do exist.\(^3\)

**Description of Affected Instruments.** Prepaid forward contracts may track any of a broad variety of assets, including a single stock, an equity index (which in turn may be either a broad index of stock market performance, such as the S&P 500, or a narrower index consisting of the stocks in companies in a particular industry), one or more commodities or commodity indexes, currencies, or publicly- or privately-traded debt instruments or indices composed of such instruments, real estate indices, or interest rate indices. Some prepaid forward contracts are publicly traded (e.g., exchange-traded notes), while others are not. Some provide for settlement only upon maturity, while others provide the buyer of property under the contract with an option to put the instrument to the seller of property under such contract. The option may be exercisable every day or every month if certain other conditions are satisfied. These contracts vary in term, but can extend up to 30 years in the case of certain exchange-traded notes. We understand, however, that even with respect to the longer-dated instruments, the holding period of the typical buyer tends to be relatively short.\(^4\)

Additionally, the degree of economic exposure to the underlying asset or assets varies among prepaid forward contracts. Many, perhaps most, prepaid forward contracts provide the buyer with the same economic exposure the buyer would achieve if it had simply bought the underlying asset. Where a prepaid forward contract provides economic exposure to assets as though the holder had purchased those assets, and also provides the buyer the right to put that contract to the seller (or possibly a third party), the prepaid forward contract economically resembles an exchange-traded fund. In some

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\(^3\) For example, a DECS-type transaction frequently provides for periodic payments.

\(^4\) While it is difficult to acquire data about particular individuals, data provided by James Peaslee to the Senate Committee on Finance in connection with that Committee’s recent hearings on the taxation of derivatives indicate that the ratio of daily trading volume to total outstanding exchange traded notes is quite high, which tends to indicate a short holding period on average.
cases, however, prepaid forward contracts provide for an exposure that replicates the
exposure a buyer would have if it had bought the underlying property and bought or sold
a combination of options on the underlying property. For example, a prepaid forward
might provide for a “buffer,” in which the buyer does not suffer from a specified
percentage in a decline of the index, but does suffer from declines below this specified
percentage (e.g., a buyer might receive all of the upside in an index, and all of the
downside after the index has declined 20%).\footnote{This would be economically equivalent to owning the assets comprising the index, buying a put on
the index struck at 100, and selling a put on the index struck at 80.} Alternatively, a prepaid forward contract
might provide for a multiplier, in which the buyer would receive twice the performance
of the index, either throughout its entire range, or through a specified range.\footnote{This contract would be economically equivalent to owning the assets comprising the index and then buying one or more calls on those assets (and, if the additional participation in the index is capped, selling one or more calls).} As a third
e xample, a prepaid forward contract may be a so-called “corridor note,” in which case the
buyer gets a large payoff if the value of the index stays within a specified range during
the term of the note, but receives nothing if it ever goes above or below this range.

There are also “bear notes” that embody a short position with respect to the index.
Finally, in addition to the notes described above, prepaid forward contracts occasionally
appear in the commercial context, most often calling for physical settlement at the end of
a relatively short term. It is difficult meaningfully to distinguish these other contexts
from the financial contracts upon which the Notice appears to focus its attention.

**Description of Affected Taxpayers.** The typical buyer in a prepaid forward
contract is an institutional investor or high net worth individual who seeks exposure to
various asset classes. Frequently, the seller in a prepaid forward contract (i.e., the party
who receives the prepayment and agrees to deliver in the future property or cash equal to
the value of such property) is a financial institution that uses a mark-to-market method of
accounting for U.S. tax purposes. However, high net worth individuals frequently (and
corporations sometimes) are sellers of stock in variable prepaid forward contracts.

**Taxation of Parties to Prepaid Forward Contracts Under Current Law.** Under
current law, it is generally accepted that both the buyer and the seller in a prepaid forward
contract should use a realization-based method of accounting. Thus, the buyer has a basis
in his prepaid forward contract equal to the amount of the prepayment, while the seller
typically has no current income inclusion. Neither the buyer nor the seller recognizes any
income or deduction relating to the prepaid forward contract during its life, except
possibly with respect to any periodic payments made on the contract. If the contract is
physically settled, the buyer generally would not recognize gain or loss on the delivery of
the reference property (unless the reference property consists of foreign currency), but
rather would take a basis in such property equal to the amount he paid at the inception of
the forward contract. If the contract is cash settled, then the buyer would recognize gain
or loss equal to the difference, if any, between the amount of cash he paid at the inception
of the forward contract and the amount of cash he received. Any gain or loss would
generally be capital (except for currency-linked contracts and hedges), and would
generally be long-term if the holding period for the prepaid forward contract was more
than one year at the time the contract was settled. From the seller’s perspective, gain or loss generally would also be capital, unless, as is often the case, the seller was acting in its capacity as dealer in securities when it entered into the forward contract and is marking the contract to market.

Questions Posed By The Notice. In the Notice, Treasury and the Service indicated that they were considering whether the parties to a prepaid forward contract should be required to accrue income/expense during the term of the transaction, even if the prepaid forward contract is not otherwise indebtedness for U.S. federal income tax purposes.\(^7\) The Notice indicated that Treasury and the Service also are considering a number of other issues associated with these transactions, including:

- The appropriate methodology for accruing income or expense, if that is deemed appropriate (for example, a mark-to-market methodology or a method resembling the noncontingent bond method set forth in Regulation section 1.1275-4);

- How an accrual regime might be designed so that it does not inappropriately or inadvertently cover routine commercial transactions involving property sales in the ordinary channels of commerce;

- The appropriate character (capital vs. ordinary, and if ordinary, whether interest) of any income accruals required under such an accrual regime, as well as the character of amounts less than, or in excess of, these accruals;

- Whether the tax treatment of the transactions should vary depending on the nature of the underlying asset (for example, stocks vs. commodities);

- Whether 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), or (ii) memorialized in an instrument that is traded on a securities exchange;

- Whether the transactions should be treated as indebtedness pursuant to regulations issued under section 7872;

- Whether section 1260 applies, or should apply, to prepaid forward contracts and similar transactions;

- The degree to which such transactions (and any income accruals that may be mandated) should be taxed under sections 871 and 881;

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• How the income with respect to such instruments should be treated for purposes of section 954 (for example, as income equivalent to interest or gains from property that does not give rise to income);

• How investments in such contracts should be treated under section 956;

• Whether there are other issues that should be considered with respect to these transactions (for example, whether short term transactions should be subject to the accrual regime);

• Identifying arrangements similar to prepaid forward contracts that should be accorded tax treatment similar to that of prepaid forward contracts; and

• Appropriate transition rules and effective dates.

II. Discussion

A. Criteria for Evaluation

In evaluating each of the methodologies for accounting for prepaid forward contracts, we took into consideration a number of different criteria. Because the selection of these criteria, as well as the weight given to each one, obviously plays a major role in our ultimate recommendations, it is worth commenting about these selection criteria and the role each one played in evaluating a particular methodology.

• Do Treasury and the Service have the authority to require or permit the method? This is, obviously, the most important criterion, because if the government lacks the authority to promulgate a particular regulatory regime, no other criterion matters. Of course, if there were compelling reasons supporting a given method, but the method could not be adopted by regulation, that would suggest that Congress should amend the Code to require or at least permit that method to be used.

• Does the method accurately reflect a party’s income (taking into account the differential treatment of ordinary income and capital gains)? Because an income tax must of necessity define “income,” it may be thought that the accuracy of income measurement should be the most important goal in adopting a regulatory regime (other than validity). In fact, however, accuracy is a fairly low priority in many areas of the Code. For example, it has been argued that, as a theoretical matter, a mark-to-market regime represents the utmost in economic accuracy, yet mark-to-market is not required to be used (except for dealers and electing traders) even for publicly-traded stocks, the value of which can easily be determined in many cases. Other practitioners,

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8 See, e.g., David Weisbach, A Partial Mark-to-Market Tax System, 53 Tax L. Rev. 95, 100-02 (1999) (proposing a separate mark-to-market regime for liquid assets with a lower tax rate).
including the majority of those who prepared this report, object that the mark-to-market method of accounting assumes that increases in wealth are properly taxed as income, and ignores the limitations of an annual income determination system and a single valuation date (which may cause capricious effects under a mark-to-market regime).

- Is the method administrable? The degree to which a particular regulatory regime is administrable is obviously an important factor. However, because all taxing regimes involve some degree of administrative burden, and nearly every taxing regime can be administered to a reasonable degree if taxpayers and the Service invest sufficient resources, the extent to which a particular regime is administrable will rarely, by itself, be determinative. A solid information-reporting regime will greatly facilitate accurate reporting by buyers under prepaid forward contracts, but may be unduly burdensome to sellers or others charged with the responsibility of tracking information and sending out statements. In addition, if the method is conceptually difficult, it may be difficult for revenue agents to ensure that taxpayers adhere to a reasonable level of compliance.

- Is the method a dramatic departure from long-established tax principles? As a legal matter, Treasury and the Service have considerable discretion to alter existing law through the regulatory process. Prudence counsels, however, that if a putative regulatory regime is entirely inconsistent with long-established tax principles, Treasury and the Service should proceed cautiously in adopting that regime.\(^9\)

- Is the method symmetrical as between buyers and sellers? Symmetry of tax treatment between parties on opposite sides of a transaction constitutes a matter of fundamental fairness. That is, if two parties are on the opposite side of a prepaid forward contract, both use the same method of accounting with respect to that transaction, and one side has income, it is self-evident that the other side should be allowed a deduction. Thus, we rank symmetry high on the list of criteria for evaluating a regulatory regime aimed at prepaid forward contracts.

- Does the method provide for similar treatment for instruments that are economically similar? This criterion is important for at least two reasons. First, the public perception that the taxing system is based on fair and neutral economic principles may be undermined if similarly situated taxpayers can achieve the same economic result with dramatically different tax results. Second, the tax system should ideally not provide taxpayers with an incentive

\(^9\) In setting forth this factor, we are not proposing that the government is bound by the so-called Wall Street rule, under which the government is allegedly precluded from challenging the tax treatment of a financial product merely because a considerable number of transactions have been executed over a sufficiently long period of time. We are merely suggesting that long-settled principles should not be lightly disturbed.
to structure their transactions in a particular way. However, notwithstanding the intuitive appeal of these two reasons, it is now well-established that different forms of investment often can result in different tax consequences, and it does not seem advisable, or even possible, to attempt at this point to eliminate all disparities. We have therefore accorded this factor relatively less weight than other factors.

B. Analysis of Available Methodologies

In general, there are five pure methodologies that could reasonably be used to account for income, gain, deduction, and loss for a U.S. taxpayer who enters into a prepaid forward contract. The first is an income accrual regime. The second is a deferred taxation method with an interest charge which would be similar to that used by section 1260. The third is a mark-to-market method. The fourth is a look-through realization regime. The fifth is the realization-based method currently in use by the majority of non-dealer taxpayers.  

1. Accrual of Income

Because the Notice focused principally on the desirability (or lack thereof) of an accrual-based regime, we discuss that regime first. An accrual regime might take any one of many forms. The most basic form would consist of a requirement that a party who enters into a prepaid forward contract as a buyer of property accrue income at a prescribed rate (presumably either the applicable federal rate or a comparable yield determined as for contingent payment debt instruments) on the prepaid amount and increase basis in the contract by the amount of the accrual. Upon the maturity or earlier settlement of the contract, the buyer would then recognize gain or loss equal to the difference between its basis in the contract and the amount realized for the contract, and such gain or loss would presumably be treated as capital (assuming the property that is the subject of the prepaid forward contract is a capital asset).

a. Authority

As mentioned above, the most critical question regarding any tax accounting regime applicable to prepaid forward contracts is whether the government has the authority to adopt this regime. For an accrual regime, the two most logical places to look for authority are sections 446 and 7872. Section 7872 deals principally with a loan made in a circumstance in which the parties intentionally forgo the payment of interest because of a personal or commercial relationship between them. An interest payment is imputed from the borrower to the lender, and then treated as paid back to the borrower as some other type of payment (e.g., a dividend, if the lender is a corporation and the borrower is its shareholder, or a gift, if the lender is a father and the borrower is his son). Thus, as a matter of form, a loan exists and section 7872 authorizes the imputation of interest. By

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10 It is also possible, of course, that the government could adopt a hybrid regime, which would incorporate features of one or more of the pure regimes. We discuss hybrid regimes at the end of the portion discussing the pure regimes.
contrast, in a prepaid forward, there is not in form a loan. Imputing a loan here would, however, arguably be authorized by the conference report to the original enactment of section 7872, which provides that, “It is intended that the term ‘loan’ be interpreted broadly in light of the purposes of the provision. Thus, any transfer of money that provides the transferor with a right to repayment may be a loan. For example, advances or deposits of all kinds may be treated as loans.”

This language is somewhat confused; the difference between an advance and a deposit traditionally is that a deposit must be refunded at the option of the payer, while an advance need not be. The conference report, however, appears to view these terms as synonymous. Thus, the last sentence conflates a deposit, which surely can be treated as a loan, with an advance, which is generally not treated as a loan, at least in the absence of regulations. Given the deference accorded to Treasury regulations, however, it appears that the legislative history could provide the necessary authority for Treasury and the Service to adopt an accrual approach for prepaid forward contracts under section 7872.

It is also possible, although not certain, that section 446(b) provides authority to require the current accrual of income with respect to prepaid forward contracts. That section provides in pertinent part that, “if the method [of accounting] used [by the taxpayer] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.” On the one hand, this language has generally been understood to grant Treasury broad latitude in the manner in which a taxpayer is required to compute its income. On the other hand, this authority has generally been applied in circumstances where the taxpayer could be required to report income currently and then be forced to accept an offsetting capital loss in a subsequent year. To the extent the taxpayer cannot use the capital loss, the taxpayer’s effective tax rate would be increased, and it is not clear that Treasury has the authority to require this result under section 446(b).

b. Accuracy

From the perspective of economic accuracy, it is not clear that extending the rules of section 7872 to the prepaid forward context would enhance the accuracy of the taxation of prepaid forward contracts. In the core section 7872 context, the lender is assured of getting his principal back, and it therefore does not seem inappropriate to treat

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12 See Commissioner v. Indianapolis Power & Light Co. 493 U.S. 203 (1990) (“The individual who makes an advance payment retains no right to insist upon the return of the funds; so long as the recipient fulfills the terms of the bargain, the money is its to keep. The customer who submits a deposit to the utility, like the lender in the previous hypothetical, retains the right to insist upon repayment in cash; he may choose to apply the money to the purchase of electricity, but he assumes no obligation to do so. . . .”). While the Supreme Court decided Indianapolis Power & Light Co. six years after the enactment of section 7872, we believe the decision reflected the common law distinction between advances and deposits that had existed for many years previously.
13 Examples of accrual regimes under current law include notional principal contracts, methods of accounting for inventory, and contingent payment debt instruments. In the first two cases, capital losses generally cannot arise, while in the third the regulations incorporated a special rule to avoid the character whipsaw.
him as receiving income equal to the interest that would accrue on that principal had the parties been dealing at arm’s length. By contrast, under a prepaid forward, the buyer is not guaranteed to get his money back; he may lose money (including, in most cases, all of his money) if the underlying instrument declines in value. Even though a taxpayer who invests funds in a prepaid forward contract does so with the expectation of receiving a positive return, presumably at least at the applicable federal rate, the taxpayer’s actual income will quite likely differ from what he expects or is deemed to expect to receive. Thus, it is highly likely that the taxpayer will be taxed on the wrong amount of income, which is not trued up until the instrument is sold or matures.

A tax regime that taxes an investor as if he had made a loan when he has no fixed return on his principal and no guaranteed right even to a return of his principal would represent a dramatic departure from the “all-events” test that forms the core of the accrual method of accounting. As a general rule, an accrual method taxpayer is not required to accrue income until the “all events” test is satisfied with respect to that income. Taken by itself, this test would not necessarily be satisfied with respect even to a plain vanilla OID debt instrument, because, during each year of the taxpayer’s holding period prior to maturity, all of the events may not have occurred that establish the taxpayer’s right to receive the income. That is, the taxpayer would not be legally entitled to demand payment if the passage of time necessary for such right to ripen has not yet occurred. Congress believed that such deferral was inappropriate, and so enacted sections 1272-1275 and section 163(e) to require holders to include, and permit the issuer to deduct, interest on the basis of an economic yield to maturity. Of course, that system of rules by its terms could be applied only if a payment schedule was known, and therefore could not be applied to a contingent payment debt instrument. In 1996, Treasury and the Service promulgated a new set of regulations to address contingent debt. Those rules had the effect of requiring a taxpayer to project the amount of payments that he would receive in the future based on the yield of a comparable noncontingent debt instrument. As such, the contingent debt rules created for the first time the meaningful possibility that a taxpayer would be required to accrue income that he would never have any legal right to receive. This approach was controversial at the time, and the rules were criticized for requiring this income accretion, and particularly for failing to adjust the accruals in situations in which it was clear that there likely would be a shortfall the projected payments. For the government now to impose an accrual regime on a taxpayer who is holding a long position under a prepaid forward contract would be a significant step beyond even the contingent debt regulations. Essentially, Treasury and the Service would be applying a pure expectations model to assert that a taxpayer is required to include amounts in income prior to realization, based on what the taxpayer expects to receive, rather than based on what it actually receives.

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It is true that something comparable would be required under the proposed contingent swap payment regulations, but those regulations were controversial when proposed and have yet to be finalized. Those proposed regulations also provide for annual adjustments, which limit the amount by which the taxpayer’s accruals can diverge from the value of the underlying property, but which also increase the complexity of those proposed regulations.
Proponents of imposing an accrual regime on prepaid forward contracts sometimes argue that a prepaid forward is economically equivalent to a loan coupled with a traditional post-paid forward and therefore should be taxed as if it consisted of the two components. While we accept this economic equivalence, we do not believe it justifies bifurcating a prepaid forward in this manner and taxing it as if it consisted of these two components. There are at least two reasons for our conclusion.

First, bifurcating a prepaid forward contract would mark a dramatic departure from the general treatment of financial instruments, both long-standing and recent, under which a single instrument is not split into components. For example, convertible debt is not treated as an investment unit consisting of a discount debt instrument and an option. Contingent debt is not split into a noncontingent debt component and a property right. An option is not recast as a loan plus a post-paid property right. Stock is not recast as a loan plus a call option minus (short) a put option. Accordingly, applying a bifurcation approach only to prepaid forward contracts would put such contracts at a significant disadvantage compared to other financial instruments and likely would have the effect of making the instrument so unattractive as to eliminate the market for the product. Applying a bifurcation approach more broadly (e.g., to some or all of the transactions described in this paragraph) would seem to be more than Treasury should attempt to accomplish by regulations.

Second, in spite of the name applied to some of these contracts (“exchange traded notes”), prepaid forward contracts more closely resemble a direct investment in the underlying stock or commodity than a loan plus a post-paid derivative. If one were to bifurcate such a contract, it is not clear why the proper split would not be into a deemed investment in the underlying property coupled with a contract to sell the property to the derivative counterparty for its fair market value at maturity of the contract. Alternatively, one might split the contract into an at-the-money long call option and an at-the-money short put option, with the net price equal to the premium paid on the forward contract.\(^\text{15}\)

Character issues pose another difficulty from the perspective of economic accuracy. If the buyer under a prepaid forward contract were required to accrue ordinary income over the term of the contract and realized a corresponding loss at the expiration of the contract, that loss would generally be treated as capital under common law. On these facts, the taxpayer would be taxed on an amount greater than its economic income unless it had capital gains from unrelated transactions against which the capital losses could be offset. In the case of an individual taxpayer, even a fully utilizable capital loss may not make the taxpayer whole (i.e., if such loss could be offset only against capital gains that would otherwise have qualified for a preferential rate). Clearly, the mere possibility of this outcome constitutes a major disadvantage to the adoption of an accrual regime. Thus, if Treasury were to adopt an accrual method, it would be desirable to provide that any losses realized at maturity would be ordinary to the extent of ordinary income accrued but not received. This would be consistent with the Neal legislation (discussed

\(^{15}\) This discussion illustrates one of the principal reasons bifurcation has not generally been adopted in the area of financial products taxation: there are often many ways to bifurcate a single financial instrument, none of which can definitively be said to be the most economically correct way.
below) and the rules for contingent payment debt instruments, which were adopted pursuant to the grant of legislative authority under section 1275(d). While Treasury arguably has the authority to promulgate such rules under the Supreme Court’s decision in *Arrowsmith v. Commissioner*, the need to alter character rules as well as timing rules does raise additional questions regarding the authority issue, particularly on a sale rather than the maturity of the prepaid forward contract.

From the perspective of comparability to other economically similar instruments, an expectations-based model is not used in other situations where taxpayers have an expectation of earning income which is presumably equally as strong as in a prepaid forward contract. For example, it is not used when a taxpayer invests in common stock of a Subchapter C corporation, a partnership, a REIT, or an open- or closed-ended mutual fund, as more extensively discussed below. Instead, each of these investment vehicles uses a look-through realization approach, which we discuss later. Nor, for that matter, is an expectations model used in situations where a taxpayer (even an accrual-basis taxpayer) expects to earn income from purchasing tangible personal property (e.g., a widget stamping machine). Once the decision has been made to require accrual on a prepaid forward contract merely because (a) the taxpayer has invested funds and (b) the taxpayer has an expectation of earning a profit at least equal to the applicable federal rate, it is difficult to see why each of these other investments should not be similarly taxed.

It could be argued that none of these circumstances involve a taxpayer with a contractual right to demand payment from a counterparty, and that such contractual right justifies requiring an accrual of income. As further support for this argument, we note that debt instruments (of which the *sine qua non* is the contractual right to demand payment) do require accrual, while many other assets that lack this contractual right (e.g., stocks and partnership interests) do not currently require accrual. Yet upon further analysis, we do not believe that the existence or non-existence of a contractual right is a meaningful touchstone to whether accrual is required under current law. For example, a holder of shares in an open-ended mutual fund does indeed have such a right; the fund is required by law to repurchase the shares from the holder for their net asset value. Yet, no accrual is required on an investment in RIC shares. More fundamentally, it is not clear why the contractual right to sell affects the analysis in a situation where the taxpayer is being required to accrue income based on an expectations model. That is, the entire rationale for requiring income accrual is simply that the buyer in a prepaid forward contract invested funds and must have expected to earn some minimum threshold return; therefore, it is appropriate to tax him annually as though he did in fact earn that return, unless and until events definitively prove otherwise. The mere fact that the taxpayer has a contractual right to liquidate its position for an amount approximating the then-fair market value of that position (i.e., a liquidity right) would not seem to strengthen this argument.

One could argue, of course, that the treatment of these other investment instruments is a historical artifact, and that such treatment should not control the treatment of a relatively new instrument, such as a prepaid forward contract. As noted

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16 344 U.S. 6 (1952).
above, we do attribute some weight to the historical context in which tax rules apply, and so we are not without sympathy for this argument. Moreover, it is also true that tax rules do change over time, and such changes can be a marked departure from past practice (e.g., the tax treatment of contingent payment debt instruments). Nonetheless, it seems to us on balance that the existence of a contractual right to sell for fair market value does not justify imputing interest income on a prepaid forward contract.

Finally, we turn to the scope of any accrual based regime. The first issue presenting itself for decision is whether an accrual regime would be symmetrical (i.e., that sellers under prepaid forward contracts be allowed a corresponding interest deduction). In our judgment, if Treasury adopts an accrual regime, it should provide for symmetrical treatment for buyers and sellers. From an authority perspective, section 7872 clearly provides for symmetrical treatment as between the borrower and the lender. While section 446(b) does not explicitly so provide, it is difficult to see how a regime could meet a clear reflection test if it required the buyer to accrue income without allowing the seller a deduction. While similar asymmetrical tax accounting regimes do exist, they are primarily statutory rather than regulatory in nature, and are arguably intended primarily to discourage taxpayers from entering into the relevant transactions, or at least are drafted with indifference to whether taxpayers actually do enter into the relevant transactions. We submit that a regime that is intended to discourage the use of prepaid forwards is inappropriate, given that prepaid forward contracts are generally understood to be used primarily for investment purposes rather than tax avoidance (albeit with a tax benefit that may be significant).

In emphasizing the importance of symmetry, we are aware that Representative Neal has introduced legislation in the House of Representatives (the “Neal Bill”) that would require an income inclusion to the buyer while not providing a corresponding deduction to the seller. While a consideration of the Neal Bill is beyond the scope of these Comments, we understand that this asymmetrical result is thought to be justified on the grounds that sellers under prepaid forward contracts are generally dealers in

For example, there is a wash sale rule for losses, but none for gains. There are constructive sale rules that trigger gains, but none that trigger losses. As a third example, the straddle rules defer losses, but not gains.

In this connection, we were somewhat surprised that the Notice referred to the desire not to “inappropriately or inadvertently cover routine commercial transactions involving property sales in the ordinary channels of commerce.” This reference suggests that Treasury is contemplating a distinction between prepaid forward contracts used as investment vehicles and those used in commercial transactions. Presumably, the former are believed to be motivated in part by tax planning concerns, and therefore appropriately subject to rules that would be too harsh in the latter context. If this is the distinction being made, we disagree with it. That is, if fundamental tax policy concerns require an accrual of income on a prepaid forward contract entered into by an investor to buy a stock index, those same concerns should also require the accrual of income if an airline enters into such a contract to buy jet fuel. If Treasury nonetheless is concerned about affecting commercial transactions if it adopts an accrual regime for prepaid forward contracts, it could limit the regime to contracts having a term of more than one year. Such a limitation, if adopted, however, should apply to all prepaid forward contracts, regardless of the underlying asset.

H.R. 4912, 110th Cong., 2d Sess.
securities, which use a mark-to-market method of accounting under section 475. We disagree with this reasoning. As noted above, individuals (and some non-dealer corporations) do enter into prepaid forward contracts as sellers, and such taxpayers rarely use a mark-to-market system of accounting with respect to these contracts. Simple fairness requires that these sellers be allowed interest deductions to the extent the buyers would have interest income. Moreover, for the majority of sellers who are in fact on mark-to-market, an accrual regime could peacefully co-exist with a mark-to-market regime.\textsuperscript{20} In any case, whatever the fundamental policy concerns are about an asymmetric regime adopted legislatively, Congress certainly has the power to adopt such a regime if it chooses. By contrast, Treasury needs authority to promulgate a regulation, and we respectfully submit there is no authority under section 7872 or, apparently, under section 446(b), to provide for inconsistent treatment of buyers and sellers under a prepaid forward contract. Thus, symmetry would appear in this context to be inextricably linked with the validity of an accrual regime.\textsuperscript{21}

One final conceptual problem involving symmetry arises in the context of a corporate taxpayer that issues a prepaid forward contract on its own stock. Clearly, on these facts, we understand that Treasury and the Service would be uncomfortable with the conclusion that an interest deduction should be allowed on the prepaid forward contract; that is why Revenue Ruling 2003-97 imposes strict requirements of separability between the note and the forward contract before an interest deduction will be allowed. As a technical matter, the interest deduction may well be disallowed under section 163(l); however, if that section had never been enacted, it is still not clear that Treasury and the Service would or should be comfortable that an interest deduction should be allowed as a policy matter. This tension between viewing the prepaid forward contract as two contracts from the perspective of the buyer but as a single contract from the perspective of the seller casts further doubt on the wisdom of adopting an accrual regime for prepaid forward contracts.

The second question of the scope of an accrual method involves instruments that do not convey to their buyers creditors’ rights (\textit{i.e.}, stock). It is theoretically possible that some of the instruments now being issued as prepaid forward contracts might instead be issued in the form of index linked preferred stock, perhaps issued by a special purpose vehicle. Such index linked preferred stock would presumably need to be brought within the scope of the accrual regime as well, although doing so would raise a host of technical issues\textsuperscript{22} and problems related to the government’s authority to issue such regulations.

\textsuperscript{20} See Prop. Reg. § 1.475(a)-1 (mark-to-market computations do not affect either the amount treated as interest earned from a debt instrument or the taxable years in which that interest is taken into account).

\textsuperscript{21} We suggest that the very largely symmetrical aspect of the CPDI regulations has contributed significantly to the degree to which practitioners and taxpayers accepted those regulations.

\textsuperscript{22} For example, would accrual of income on preferred stock be contingent on the issuer having earnings and profits? Would the dividends-received deduction be available for a corporate buyer, or the preferential rate available under current law for an individual shareholder? How would the line be drawn between index-linked preferred that would be subject to the accrual regime and other types of stock that would not be so subject?
The third question of scope involves prepaid forward contracts whose payment amount does not correlate perfectly with the value of the underlying property or index. For example, how should an accrual regime draw the line between a prepaid forward contract and a deep-in-the-money call or put option? Assuming the tax system required income accrual on a prepaid forward but generally not on options (unless such options were so deep-in-the-money as to be forward contracts in substance), taxpayers who did not wish to have to accrue income on a prepaid forward contract might decide to denominate their investment contract as an option with a low strike price. While the Service could certainly challenge this approach successfully in an extreme case, it would be difficult to draw a line that would be both theoretically justifiable and practically administrable. If the Service did draw such a line, integration rules would presumably be needed so that a taxpayer could not purchase a (non-deep-in-the-money) call and at the same time (or possibly later) sell a put, thus restoring complete exposure to the underlying (albeit with a lower investment on which to earn deferred gain).

If Treasury and the Service do not wish to draw a line between options that were so deep-in-the-money as to require accrual and those that were not, they could extend the section 7872 approach to all options, and simply require an accrual of interest on the option premium. While this would be more administrable and conceptually justified than drawing a line between options and prepaid forward contracts, it would also constitute a major change to the traditional treatment of options. Moreover, it would be somewhat odd as a commercial matter to bifurcate every option into a combination debt instrument and postpaid option because postpaid options have not traditionally existed. Thus, unlike the disaggregation of a prepaid forward contract into a regular forward contract and a debt instrument, both of which are traditionally recognized types of instruments, one would be disaggregating an option into a debt instrument and a postpaid option, the latter of which is virtually unheard of. We conclude, then, that while Treasury and the Service may have the authority to require the accrual of income on a prepaid forward contract, doing so would be inconsistent with fundamental tax policies.

2. Section 1260

A second possibility for the treatment of prepaid forward contracts arises out of section 1260, which generally provides that if a taxpayer has gain from a constructive ownership transaction that otherwise would be long-term capital gain, the gain is treated as ordinary income to the extent it exceeds the “net underlying long-term capital gain” (i.e., the gain that would have been capital gain if the taxpayer had owned the financial

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24 A delta-based approach, in which an option would be treated as a forward contract if, and only if, its delta exceeded some pre-determined percentage (e.g., 80% or 90%), would be theoretically justifiable, since a prepaid forward contract has a delta of 1.00, while most commercially issued options have deltas that are much lower (e.g., 40%-60%). However, measuring the delta is somewhat subjective, especially because it relies on the volatility of the underlying asset, the determination of which is often subject to varying interpretations. Further, while financial sophistication is unquestionably high among taxpayers that design and invest in prepaid forward contracts and options, a tax rule based on the delta of an option would entail a significant leap in the complexity of the tax system.
asset directly). Additionally, the statute requires a portion of the recharacterized ordinary income to bear a charge in the nature of interest, as though the amount had been received in prior years (without actually requiring the taxpayer to file amended returns for those years).

In considering the authority of Treasury and the Service to adopt a section 1260-based regime, it is also necessary to consider the scope of such a project. The definition of constructive ownership transaction explicitly includes a forward contract, which clearly also includes a prepaid forward contract. In addition, the definition of “financial asset” in section 1260 includes an equity interest in a pass-through entity and, “to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-through entity.”

25 This appears to provide sufficient authority to permit Treasury and the Service to issue regulations that extend section 1260 to prepaid forward contracts where the underlying is stock and, quite likely, where it is an index on a group of stocks. However, we submit that Treasury and the Service would not have authority to extend section 1260 to prepaid forward contracts where the underlying is, for example, an index on commodities or currency. Thus, any regulations imposed on prepaid forward contracts would create a disparity in treatment between prepaid forward contracts based on equity or an equity index or on debt, on the one hand, and those based on other assets or indices, on the other hand. Additionally, section 1260 does not appear applicable to contracts that provide sub-delta one exposure to the underlying, such as barrier notes or DECS-type kinked settlement formulas (i.e., those with an embedded call spread).

26 Turning to a discussion of the accuracy of a section 1260-type regime, we note that section 1260 possesses several design features that render it unsuitable for use in crafting a method of accounting for prepaid forward contracts. Section 1260 appears, as a practical matter, to have been intended to deter taxpayers from entering into the transactions that are within its scope. It produces non-economic results in several ways. First, even if the underlying income from the pass-through entity would have been short-term capital gain, section 1260 treats such income as ordinary. Thus, any capital losses that the taxpayer might have may not be used to offset the income. Second, the manner in which section 1260 spreads the ordinary income over time will frequently work to the disadvantage of taxpayers. That section requires the gain to be spread over the taxpayer’s

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25 Section 1260(c)(1).
26 Under section 1260, a taxpayer is treated as having entered into a constructive ownership transaction with respect to any financial asset if the taxpayer (A) holds a long position under a notional principal contract with respect to the financial asset; (B) enters into a forward or futures contract to acquire the financial asset; (C) is the holder of a call option, and is the grantor of a put option, with respect to the financial asset and such options have substantially equal strike prices and substantially contemporaneous maturity dates, or (D) to the extent provided in regulations prescribed by the Secretary, enters into one or more other transactions (or acquires one or more positions) that have substantially the same effect as a transaction described in (A), (B) or (C). The definition of “notional principal contract” and “forward contract” appear to contemplate that the taxpayer needs to have exposure to all (or at least substantially all) of the investment yield, and suffers all (or at least substantially all) of the loss, on the underlying property. Accordingly, if the taxpayer lacks exposure to substantially all of the appreciation and substantially all of the depreciation on the underlying property, the transaction will not be within the scope of section 1260.
holding period based on the assumption that the gain accrues at the applicable federal rate, rather than at the internal rate of return of the investment.\textsuperscript{27} Thus, compared with a rule that required the gain to be spread based on the internal rate of return of the investment, section 1260 operates to push the gain back to the earlier years during which the contract is in effect, and thereby increases the amount of interest that the taxpayer owes the government.\textsuperscript{28} Third, section 1260 imposes an interest charge at a rate (the Federal short-term rate plus three percentage points, which may be higher than a taxpayer’s funding rate. Therefore, the economic detriment to the taxpayer is greater than if the taxpayer had held the underlying investment, realized the gain currently, and paid the tax thereon.

As discussed above, we believe that symmetry of treatment between buyers and sellers is an important factor in determining the degree to which the government is comfortable with the accuracy of a particular regulatory regime. It is highly likely, however, that extending section 1260 to prepaid forward contracts would result in a lack of symmetry between buyers and sellers. As a legal matter, we submit that Treasury and the Service have no authority to extend section 1260 to those who were short under a prepaid forward contract. We would find the resultant lack of symmetry troubling. It is true that the statutory scheme of section 1260 does contemplate an asymmetry between the treatment of buyers and sellers. Such asymmetry has the economic effect of strongly discouraging sellers who are not on a mark-to-market method of accounting from entering into contracts subject to section 1260. While this may have been an appropriate choice for Congress to make in an attempt to discourage these contracts from being entered into (on the short side) by taxpayers who were not on mark-to-market (or with disregard for whether such issuance was discouraged), Treasury and the Service should be wary about extending this regime further, given the important investment goals served by prepaid forward contracts. As noted above, we think symmetry is an important consideration in crafting any set of regulations that deal with prepaid forward contracts, as with other vehicles that are primarily intended to accomplish an investment goal, albeit in a tax-efficient manner.

In considering the potential lack of symmetry that would result here, we are not comforted by the fact that many sellers under prepaid forward contracts would use a mark-to-market system and therefore would be under an entirely different income tax regime than a section 1260-based regime. In an analogous area, the vast majority of parties who have entered into short positions in equity swaps are dealers; yet the relevant regulations and proposed regulations apply equally to long and short positions. This is based on a fundamental notion of tax fairness. Phrased more starkly, if the government wishes taxpayers who are buyers under prepaid forward contracts to live with the results of the rules it crafts, it should itself be content to apply those rules to sellers who are not dealers, regardless of whether such sellers constitute a large or small portion of the universe of sellers under prepaid forward contracts. Thus, the lack of symmetry under a

\textsuperscript{27} Section 1260(b)(2) (first sentence).

\textsuperscript{28} This statement assumes, of course, that the taxpayer’s internal rate of return from the investment is greater than the applicable federal rate on the date the investment was entered into. This will frequently be the case.
section 1260-based approach would itself be sufficient grounds for rejecting that
approach.

In summary, then, while the government does have authority to issue regulations
under section 1260, any such regulations would not apply to prepaid forward contracts in
which the underlying was anything other than stock or debt. Nor would such regulations
apply to prepaid forward contracts that do not convey the same exposure, or substantially
the same exposure, to the underlying property as actual ownership would have conveyed.
Moreover, with respect to the contracts to which this putative regulatory regime did
apply, such regime would likely be overly harsh. A section 1260-based regime would not
be symmetrical, which would raise serious concerns about its overall fairness. On
balance, then, we conclude that any benefits that might be thought to result from
including forward contracts under a section 1260-type regime would be more than offset
by the disadvantages of such a regime.

3. Mark-to-market

A mark-to-market regime is sometimes viewed as the most accurate measurement
of income, and we therefore felt compelled to include a discussion of such a regime in
our comments. It is not clear, however, that Treasury and the Service have the authority
to impose such a regime. The authority to write regulations under the Code generally
stems from one of two areas: the general grant of authority provided under section 7805
or a specific grant of legislative authority. Except as specifically discussed herein, the
government has no authority under any Code section to write legislative regulations that
relate to prepaid forward contracts. Moreover, while section 7805 allows the Treasury to
write all “needful” regulations “under the Internal Revenue Code,” the treatment of
prepaid forward contracts is well-established under fundamental general tax principles,
including those established by court cases. Accordingly, Treasury may have only limited
scope in this area to provide rules that are “needful.”

There is considerable authority under section 446 to issue regulations prescribing
a taxpayer’s method of accounting, and it is possible that such authority could be used to
require the use of a mark-to-market regime. When the character consequences of such
requirement are considered, however, it is not at all clear that such authority exists or, if it
does exist, that it should be applied here. The “method of accounting” principle affects
only the timing of a taxpayer’s income; it does not provide the government with authority
to change the amount of the taxpayer’s losses or gains or to alter the character of those
losses or gains. Given this background, consider the results if the government were to
impose a mark-to-market regime by regulation without changing the character of gains
and losses from capital to ordinary or permitting a special carryback of losses. A
taxpayer could be forced to recognize a capital gain in one year, followed by an offsetting
capital loss in a later year. Unless the taxpayer had other capital gains in the later year,
the capital loss might never be used or might be used only after a considerable period had

29 We understand that it was the concern that the government lacked the authority to promulgate
regulations that made mark-to-market gains and losses ordinary that prompted the enactment of
section 475.
elapsed. If the capital loss were never used, the taxpayer’s total lifetime income would have essentially been increased, which the government has no authority to do. If the capital loss were used only several years after the gain were recognized, the resulting distortion would appear to cast substantial doubt on whether the mark-to-market regime clearly reflected the taxpayer’s income. In either case, it is not clear that section 446 would provide authority to require taxpayers to use a mark-to-market regime.

As noted above, a mark-to-market regime is sometimes said to have the advantage of accuracy. It is not clear to us, however, that this is indisputably true. First, to the extent the character issue discussed in the preceding paragraph does not call into question the validity of a mark-to-market regime, the potential for character mismatches certainly raises questions about how accurately such a regime would reflect a taxpayer’s income (*i.e.*, it is possible that a mark-to-market regime could be valid, while still resulting in the inaccurate measurement of a taxpayer’s income). 30 While it is the case that, under a Haig-Simons definition of an income tax, income equals consumption plus (or minus) any addition to (or subtraction from) a taxpayer’s wealth, it is not clear to us that this familiar definition of the ideal tax base reflects economic reality. In particular, it is not clear that individuals consider their ability to pay to have increased by the full amount by which their assets have increased in value, because subsequent movements in the market may eliminate the gains. It is perhaps this factor, and not merely the administrability requirement, that has thus far prevented the mandating of mark-to-marking of the vast majority of transactions for taxpayers who are not dealers.

Whatever advantages a mark-to-market regime may have, it suffers from a lack of administrability. In general, in order for a mark-to-market model to be administrable, taxpayers must be able to determine the value to which their prepaid forward contracts should be marked, and the Service must be able to satisfy itself that this value is reasonably accurate. Many prepaid forward contracts (*e.g.*, exchange-traded notes) are traded on markets with sufficient liquidity to establish a market price. (Indeed, we understand that it was the development of ETNs that prompted the current interest in prepaid forward contracts generally.) However, many such contracts will not trade on markets or will be so lightly traded that the prices resulting from such trading will be unreliable. For contracts in this group, some taxpayers will decide to follow their financial accounting treatment, if such treatment also requires marking-to-market. Alternatively, if the prepaid forward contract is entered into with a financial institution, the institution will frequently be on mark-to-market itself, and could be made to disclose this information to their counterparties. (These institutions, however, can be expected to

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30 In a related point, such character mismatches would be fundamentally unfair. The fundamental tax policy consideration for the limitation on capital losses is based on the theory that a taxpayer can generally choose the timing of realization with respect to a capital asset. Accordingly, if capital losses could be deducted freely against ordinary income, an investor could seriously distort its income by triggering capital losses and letting its capital gains defer indefinitely. But the taxpayer’s ability to engage in such selective realization is thwarted by a mark-to-market requirement, which triggers gain automatically. It would therefore be patently unfair for Treasury to issue regulations that would force the taxpayer to realize a loss, and then tell him, in effect, that he cannot use that loss against his ordinary income. Such dishonesty, it appears, must be dealt with by Congress, rather than through regulations.
object to be required to disclose proprietary information to commercial counterparties. Such objections strike us as legitimate.) Regarding the latter requirement for a mark-to-market regime (i.e., the requirement of a mark for non-U.S. tax purposes), while this condition is certainly satisfied for many taxpayers who enter into prepaid forward contracts (i.e., more sophisticated institutional buyers), it will equally certainly not be satisfied for all of them, especially the relatively less sophisticated buyers who tend to hold ETNs. Finally, mark-to-market has also traditionally been thought difficult to administer because of the necessity for a taxpayer to report income in the absence of cash. Thus, any attempt to impose mark-to-market on financial accounting reporting raises serious administrability problems.

Finally, another potent argument against a mark-to-market system is the comparability argument. That is, of all investment products (stocks in C corporations, open-ended mutual funds, closed-ended mutual funds, partnerships, etc), the only assets that an investor who is not a dealer is required under section 1256 to mark to market are regulated futures contracts, foreign currency contracts, and nonequity options (in each case, within the meaning of section 1256). Imposing a mark to market regime on prepaid forwards, then, but not other comparable instruments would result in radically different treatment for prepaid forward contracts compared with many comparable investment products. Given our understanding that Treasury is not prepared to require (and likely lacks the authority to require) that all comparable investment products, including publicly traded common stock of a C corporation, be marked-to-market, it also should not require that prepaid forward contracts be marked to market.

4. Look-through realization

As noted above, we believe it is important to try to maintain, to the extent consistent with other tax policy objectives, competitive parity between mutual funds, hedge funds, and other similar vehicles on the one hand (collectively, “Investment Vehicles”) and prepaid forward contracts, on the other hand. Investment Vehicles are generally similar to prepaid forward contracts economically for three reasons. First, like an Investment Vehicle, a prepaid forward contract (but not a regular forward contract) requires an initial capital investment. Second, both an Investment Vehicle and a prepaid forward contract, but not a debt instrument, provide full exposure to the risk of downside movements in the price of the underlying assets. Third, both prepaid forward contracts and Investment Vehicles track the performance of a group of assets that may change over time. We also agree with some of the other comments made regarding the Notice to the

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31 While this problem arises in other areas of the Code, for example, including the payment in kind of amounts subject to withholding under section 1441 or the receipt of property pursuant to a taxable exchange, these situations result from a taxpayer’s decision to pay amounts in kind, or engage in a taxable exchange rather than a sale. By contrast, the imposition of tax without cash in a prepaid forward context would simply be as a consequence of the taxpayer’s decision to enter into a prepaid forward contract.

32 There are at least two important differences between a prepaid forward contract and an Investment Vehicle. First, an investor in a prepaid forward contract faces the risk that his counterparty will not pay off. Thus, the value of the reference investment may well increase, yet the taxpayer could have an economic loss as a result of this credit exposure to his counterparty. This generally
effect that the current regime permits buyers under prepaid forward contract to benefit from tax treatment that is, generally, somewhat more advantageous than the tax treatment accorded shareholders in mutual funds. Because mutual funds are effectively taxed as pass-through vehicles, we thought it worthwhile to consider whether a similar approach could be applied to prepaid forward contracts (the “Look-through Realization” approach). Thus, treating a party who is long a prepaid forward contract as having recognized gain or income on the prepaid forward to the extent a holder of the underlying property would have recognized such gain or income may appear to provide parity between prepaid forward contracts and the class of most nearly comparable investments. As the following discussion indicates, however, such an approach would suffer numerous drawbacks.

From an authority perspective, there is no authority to issue legislative regulations requiring a look-through modification approach to accounting for prepaid forward contracts. On the other hand, any such approach arguably could constitute an interpretation of section 1001. Given the vagueness of the term “realized”, Treasury may well have authority to adopt a look-through realization regime.

From an accuracy perspective, however, the case for adopting such a regime does not appear clear cut. When the underlying assets in a prepaid forward contract change pursuant to a change in an index, the taxpayer has not, in a traditional tax sense, realized the gain (or loss) inherent in the changed portion. Rather, such gain is still subject to being wiped out by subsequent losses in the index. Thus, as an economic matter, the taxpayer has not sufficiently separated itself from the underlying asset to justify taxing him or her under a realization-based tax system.

While Investment Vehicles and prepaid forward contracts are economically similar, they are legally quite distinct. This is significant, given the importance traditionally accorded legal form in determining the tax consequences of a financial transaction. An Investment Vehicle is a taxable entity, or in the case of a partnership, an entity with respect to which taxable income, but not tax liability, is computed. By contrast, a prepaid forward contract is a derivative. The tax law generally has not treated a holder of a derivative as holding the underlying assets reflected by the derivative. Of course, the look-through realization method would not actually treat the prepaid forward contract as though the buyer owned the underlying assets; rather, it would simply require

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34 This comment was earlier made by the Securities Industry and Financial Markets Association. See SIFMA Comments on Tax Treatment Of Prepaid Forward Contracts, 2008 TNT 120-27 (June 20, 2008). Of course, additional issues arise if the terms of the index are subject to change at the behest of a related party. We do not address this situation in these Comments.
the recognition of gain with respect to a portion of the contract. However, the Treasury has only very limited authority to require gain to be recognized with respect to a capital asset where the asset has not been disposed of and where the taxpayer’s rights as embodied in that asset have not changed. Moreover, if the government were going to make a distinction of this kind, it seems irrelevant whether the buyer has prepaid the purchase price upfront or not. That is, if an event has happened regarding the underlying contract, and the event is of such a nature that the buyer and the seller should recognize gain or loss, the amount of the investment that the buyer has made, or that the seller has received, seems irrelevant. Under this theory, the deemed look-through realization rule should apply to all forward contracts, whether or not prepaid. Indeed, logically it should apply to other types of derivatives, such as options and swaps, as well.

Putting aside the question of scope, for certain kinds of prepaid forward contracts, it is not obvious what the economically correct answer would be under a look-through approach. Consider, for instance, an index that consists of five stocks. Suppose also that a prepaid forward contract provided for the buyer to receive 100% of the negative performance in the index, but also provides for 200% of the positive performance of the index, subject to a cap. Suppose further that, at a point three years before the contract matures, one of the five stocks is replaced. Under a look-through approach, how much gain should the taxpayer recognize? The answer is complicated by two factors. First, it is not clear what percentage of the replaced stock the taxpayer should be treated as owning. This can most easily be understood by considering how the taxpayer’s counterparty would hedge its position under the prepaid forward contract. On the assumed facts, depending on the price, interest rate, and the volatility of the replaced stock, the counterparty may hold more or less than one share to hedge its position. Essentially, the dealer’s position here mirrors the taxpayer’s position. Yet determining how many shares of stock the taxpayer should be treated as owning would require the taxpayer to know the delta of its position. In other contexts, such as section 1259, the Treasury has resisted issuing regulations that required a taxpayer to determine the delta of a position, even where, as under section 1259, the policy considerations of the relevant Code section would seem to support it. There is even less of a reason to require a taxpayer to determine its delta here, where no tax policy considerations require it.

The question of symmetry also arises with a look-through approach. Obviously, for each dollar of gain that one party has, the other party will have a dollar of loss. Apart from the potential application of the wash sale rule, it is not clear why this loss would not be recognizable currently if the corresponding item of gain were recognized currently. We recommend that if Treasury adopts a look-through realization approach to taxing the buyer under a prepaid forward contracts, it should adopt the same approach for taxing the seller.

Notwithstanding the initial appeal that a look-through realization approach would have from the perspective of achieving a competitive balance with Investment Vehicles,
it is difficult for us to recommend the adoption of this method of determining taxable income for a buyer under a prepaid forward contract.\textsuperscript{35}

5. Realization-based

This is the approach that generally applies under current law to the taxation of prepaid forward contracts. Because it is current law and reflects the results of numerous court decisions, concerns about a lack of authority do not arise. Administrability of this method is easy. Additionally, the realization-based method produces symmetric results for both parties. The realization-based method arguably lacks economic accuracy, as it permits considerable deferral and, to some extent, the conversion of ordinary income to long-term capital gain. On the other hand, a considerable degree of deferral is also a feature of comparable products, including open-ended mutual funds, exchange traded funds, common stocks, and hedge funds (although this deferral does not extend to dividend reinvestment programs). Moreover, practitioner and taxpayer acceptance and understanding of the realization-based method is high. On balance, then, we recommend retaining the current recognition-based method of accounting for income on prepaid forward contracts.

C. Hybrid Methodologies.

Of course, it is also possible that one or more of these regimes could be combined, with the taxpayer either given a choice of which method to use, or required to use one or more methods. For an example in the statutory context, the Neal Bill would cap each year’s accruals by the actual increase in value of the underlying, with any shortfall being carried forward to subsequent years. From a policy perspective, we are perplexed as to why this hybrid of accrual and mark-to-market accounting would be considered appropriate. That is, if the Service has sufficient confidence in the market value to limit the accrual of interest, it is not clear why taxpayers would not be required take into account increases in value beyond the amount accrued, nor why taxpayers should not be permitted to claim losses where the value of the reference asset is plummeting.

Alternatively, Treasury might consider a regime that gives taxpayers choices, for example, between mark-to-market, a look-through realization-type of regime, and a section 1260-type regime. In general, in the interest of keeping this report brief and (reasonably) timely, we do not address potential combination methods. Many of our thoughts on any such potential hybrid method can be discerned from our comments regarding the individual components. In any event, we would be pleased to comment on a particular hybrid method in a future report if it would be helpful.

\footnote{From a larger policy perspective, one solution to achieving a competitive balance between the treatment of prepaid forward contracts and the treatment of certain investment vehicles, including mutual funds, would be for Congress to enact legislation permitting the holders of mutual funds shares to exclude dividends and capital gains from income to the extent such amounts were reinvested in the fund.}
D. Prepaid Forward Contracts with Current Payments

While we commend Treasury and the Service on their interest in the timing and character issues arising out of prepaid forward contracts that do not provide for current payments, we believe it is important to provide guidance for those contracts that do. Under current law, the choices seem to be to treat the periodic payments as (i) interest on a debt instrument that is embedded in the prepaid forward contract (i.e., because the prepaid forward contract is treated as a regular forward contract and a debt instrument, as discussed above), (ii) a return to the buyer of amounts he paid under the prepaid forward contract (i.e., as not producing current income to the buyer nor a current deduction to the seller, but as reducing the buyer’s eventual basis in the property and the seller’s eventual amount realized on the sale), (iii) as ordinary income to the buyer and as a deduction to the seller as a payment for the use of non-equity capital or (iv) as ordinary income or capital gain to the extent that the taxpayer would have had such income or gain under either a look-through realization or mark-to-market approach. In our judgment, the second method appears fairly consistent with a realization based approach to the contract. If this approach were adopted, in addition to the results set forth above, the periodic payments generally would not be subject to U.S. withholding tax even if paid to a non-U.S. person. The fourth approach might be viewed as more accurate, but it would be quite difficult to administer.

On the other hand, if Treasury and the Service decide to adopt an accrual methodology for prepaid forward contracts that do not require periodic payments, a similar methodology should be adopted for contracts that do require such payments. Clearly, it would make little sense to treat actual payments made on a prepaid forward contract as constituting a return of capital while deemed payments were treated as income.

E. International Issues

In the realm of Subpart F, we think that entering into a prepaid forward contract could legitimately be treated as an investment in United States property within the meaning of section 956. Certainly, from a policy perspective, there could be few reasonable objections to such a rule, since the effect of the prepaid forward is a repatriation of funds to the same degree as the issuance of a debt instrument. And it is likely that section 956(e) does provide Treasury the authority to promulgate regulations that reach a prepaid forward contract. However, we question whether the time and effort involved in issuing such a regulation are justified based on the volume of existing transactions.

From the perspective of section 954(c), there is an issue regarding how gains and losses on such prepaid forward contract should be treated. Here, the only important thing is that all types of income, gain, deduction, and loss on a prepaid forward contract should be in

36 Section 956(e) provides that “the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations to prevent the avoidance of the provisions of this section through reorganizations or otherwise.”
the same category of foreign personal holding company income. Otherwise, a taxpayer could suffer a category mismatch that could subject it to non-economic levels of taxation.