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# WILL A VARIATION LEAD TO CONSISTENCY? IMPLICATIONS OF FORWARD CONTRACT RULING FOR HEDGING APPRECIATED STOCK

By James H. Combs

James H. Combs is a partner in the Tax, Estate Planning, and Probate department of Honigman Miller Schwartz and Cohn LLP, Detroit.

This article examines the federal income taxation of a forward sale of securities using a "variable prepaid forward contract." The author reviews an IRS revenue ruling that provides useful guidance under the common law for structuring these contracts, but also raises additional questions for taxpayers that vary their facts from those set forth in the ruling. The author also explores the potential implications of the ruling's conclusion under section 1259 for taxpayers entering into economically equivalent transactions.



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On January 16, 2003, the Internal Revenue Service published Rev. Rul. 2003-7, 2003-5 IRB 363, *Doc 2003-1634 (11 original pages), 2003 TNT 12-13*, which addresses whether entry into a prepaid forward sale of a variable number of shares of publicly traded stock results in an actual sale under section 1001 or a constructive sale under section 1259.[1] Rev. Rul. 2003-7 concludes, based on the stated facts, that execution of the forward contract does not result in either a common law sale or a constructive sale. By issuing this revenue ruling, the IRS has established conditions under which a taxpayer seeking to simultaneously hedge and monetize a position in appreciated stock without the current realization of gain will not be challenged.

This article reviews the taxation of a forward contract for the sale of securities, with a particular focus on the use of "variable prepaid forward contracts" (VPFCs), such as the one described in Rev. Rul. 2003-7. The tax deferral that is afforded by VPFCs relies on navigation of the common law sale rules and the statutory constructive sale rules. This navigation requires an understanding of how tax ownership of securities varies from tax ownership of other types of property and how economic risk and opportunity can affect the taxation of securities positions. The publication of Rev. Rul. 2003-7 provides answers on both the application of the common law and constructive sale rules, and on other issues regarding prepaid forward sales (for example, it does not treat such a contract as a "debt" for federal income tax purposes). However, the revenue ruling also raises additional questions directly or by implication. In particular, the tax consequences of varying from the facts of the revenue ruling under the IRS's interpretation of the common law sale authorities are not certain, nor is it clear what Rev. Rul. 2003-7 portends for the consistent tax treatment of VPFCs that may potentially be analyzed under other provisions of section 1259 or for economically equivalent financial transactions that may be addressed in future guidance. Each of these issues is explored in greater depth herein.

[1] All "section" or "Treasury regulation section" references are to sections of the Internal Revenue Code of 1986, as amended, or the regulations thereunder, respectively, unless otherwise indicated.

## I. Forward Sales of Securities

Taxpayers have historically used a number of financial instruments-based hedging strategies to change the nature of their investment or to reduce the risk of owning an appreciated securities investment.[2] These hedging strategies could be combined with a "monetization" of the securities whereby the taxpayer effectively cashed out the position.[3] By monetizing the gain in an appreciated position in one issuer's securities, the taxpayer could increase liquidity and diversify his portfolio. Under common law principles, the "tax ownership" of the appreciated securities did not shift, so the hedging and monetization did not constitute a taxable "realization" event. Therefore, the taxpayer did not have taxable gain on entry into the hedging and monetization transaction even though the taxpayer had received cash and, to various degrees, transferred the risk of economic depreciation and the opportunity for economic gain to another party. Instead, the taxpayer achieved tax deferral and the current use of funds that exceeded the amount of after-tax proceeds that would have been available for reinvestment had the taxpayer actually sold the appreciated securities.[4]

### A. Forward Contracts Under the Common Law

**1. Federal income taxation of forward sales.** One hedging strategy uses a forward contract for the sale of appreciated securities held by the taxpayer.[5] A forward contract is a privately negotiated and unregulated executory contract for the future delivery of a specified quantity of property for a set price.[6] The agreement to deliver the securities for a set price in the future renders the taxpayer neutral regarding price movements.[7] If the value of the securities declines, the forward seller will nevertheless receive at settlement the price agreed on at the execution date; if the value of the securities rises, the forward seller does not share in this growth.[8] The projected dividends are generally priced into the forward sales price, and adjustments may or may not be made if the dividends paid on the securities do not match the parties' expectations.[9] If adjustments are not made, the forward seller benefits if actual dividends exceed projected amounts.

Under the common law, an executory contract such as a forward sale remains an "open" transaction until the settlement date, when the forward seller delivers the property.[10] The performance of the seller is the

[2]*See* Edward D. Kleinbard, "Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System," 69 *Texas Law Review* 1319 (May 1991); Deborah H. Schenk, "Taxation of Equity Derivatives: A Partial Integration Proposal," 50 *Tax Law Review* (Summer 1995); Kevin Dolan and Carolyn DuPuy, "Equity Derivatives: Principles and Practice," 15 *Virginia Tax Review* 161 (Fall 1995).

[3]Transactions range from a pledge of property as collateral for a loan to transactions using financial products. *See* Andrea S. Kramer, *Financial Products: Taxation, Regulation and Design*, section 24.07[C], Aspen Publishers, 3d Ed. (2003 Supplement); David H. Shapiro, 188 *Tax Management Portfolio, Taxation of Equity Derivatives. See also* Deborah L. Paul, "Another Uneasy Compromise: The Treatment of Hedging in a Realization Income Tax," 3 *Florida Tax Review* 1 (1996); Thomas J. Boczar and Mark Fichtenbaum, "Stock Concentration Risk Management Strategies," *Trusts and Estates* 34 (June 1996); and Deborah L. Paul, "'Dispositions' Using Financial Instruments," 55 *New York University Institute on Federal Taxation* part 1, ch. 19 (1997). The Boczar and Fichtenbaum article also notes Federal Reserve margin rules that may restrict the extent of the monetization. These rules can affect a taxpayer's decision to employ one type of hedging and monetization strategy over another. Taxpayers' ability to hedge may be limited by various other rules. *See* David M. Schizer, "Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility," 100 *Columbia Law Review* 440 (March 2000).

[4]Perhaps the best known of these hedging and monetization strategies is the "short-against-the-box" transaction, in which a taxpayer who owns stock in a corporation sells short identical shares. The taxpayer did not realize gain or loss on the transaction until shares were delivered to close the short sale. *See, e.g., Bingham v. Comm'r*, 27 B.T.A. 186 (1932); Rev. Rul. 72-478, 1972-2 C.B. 487; and Treasury regulation section 1.1233-1(a)(1), (4). An additional tax benefit was achieved if the taxpayer died while the short sale was open because the adjusted basis in any appreciated shares held by the taxpayer was stepped up at death to fair market value under section 1014, thus eliminating federal income tax on the appreciation in those shares. *See* Rev. Rul. 73-524, 1973-2 C.B. 307. Section 1259, discussed below, has diminished the use of short-against-the-box transactions. Short sale transactions are governed by section 1233.

[5]This article assumes that the forward seller is an individual holding the appreciated stock as an investment and is not a taxpayer subject to the mark-to-market rules of section 475 or the business hedging rules of section 1221.

[6]*See Estate of Leon Israel Jr., et al. v. Comm'r*, 108 T.C. 208, 235, *Doc 97-9274 (52 pages)*, *97 TNT 63-8* (1997) (dissent of J. Halpern), *rev'd on other grounds* 148 F.3d 186 (2d Cir. 1999); *Glass v. Comm'r*, 87 T.C. 1087, 1101 (1986). Most authority for the tax treatment of forward sales has been developed by the courts. Congress has addressed forward sales on occasion. *See, e.g.*, section 1258 (conversion transactions), section 1256 (mark-to-market of exchange-traded "regulated futures contracts"), section 1259 (constructive sale rules), and section 1260 (constructive ownership rules).

[7]A taxpayer who does not own the property that he agrees to deliver in the future is subject to price fluctuations because his cost to cover the forward delivery obligation increases if the price of the underlying property rises before the settlement date.

[8]Forward contracts are priced based on the cash-and-carry method, which takes into account the forward seller's carrying costs over the term of the forward contract (e.g., insurance, interest expense, etc.) and expected price movements for the underlying property. *See* David F. Levy, "Disparities in Treatment Among Prepaid Forward Contracts, Deep in the Money Options, Prepaid Swaps, and Contingent Debt Instruments," *Derivatives* (November/December 1998) at 5.

[9]Under the recently passed Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27, May 28, 2003), qualified dividends are taxed at long-term capital gains rates, unless excluded. Excluded dividends include dividends received on stock that the taxpayer has hedged under the rules of section 246(c). This would appear to include dividends received during the term of a forward contract. *See* Jasper L. Cummings, Jr., "Planning With the New Rate and Corporate Changes Made by JGTRRA," 99 *Journal of Taxation* 1 (July 2003) (discussing the coordination of the new dividend rules with section 246(c)).

[10]*See, e.g., Lucas v. North Texas Lumber Company*, 281 U.S. 11 (1930); *John C. Stanley, III v. U.S.*, 599 F.2d 672 (5th Cir. 1979) (a taxpayer's holding period for debentures commenced on the date of the purchase, not on the date he agreed

**(Footnote 10 continued in next column.)**

operative event that completes the sale. Therefore, the execution of the forward contract is not a taxable sale of the underlying property, and gain or loss, if any, is not realized by the forward seller until delivery of the property to settle the contract.[11] Holding the forward sale open takes into account the fact that the forward seller's basis in the property to be delivered cannot be determined until settlement.[12] This is especially true when the forward seller has a "cash settlement" option, pursuant to which shares may not be delivered at all. A "cash-settled" forward (as opposed to a "physically settled" forward) permits the forward seller to pay the forward purchaser the difference between the forward sales price and the spot price of the property on the settlement date rather than deliver the property to close the transaction; if the price of the underlying property declines over this period, the forward purchaser would make a corresponding payment to the forward seller.

For forward sales of securities, holding the forward sale open until settlement is also consistent with the share identification rules in the regulations under section 1012. Even though shares of stock are generally fungible (that is, one share of stock in an issuer is no different than another share of the same class of stock in that issuer), Treasury regulation section 1.1012-1(c)(1) permits a taxpayer to identify the specific shares that will be delivered at settlement. If the taxpayer cannot identify the shares as required in the regulations, then a first-in, first-out rule applies.[13] The share identification rules offer an additional ground for holding the sale open because the forward seller may deliver unappreciated shares he owns or may close the sale with other shares purchased on the open market immediately before settlement.

The tax consequences to the parties to the forward contract depend on whether the forward seller delivers shares at settlement or cash settles. If the contract is physically settled, the forward seller has completed a sale of the shares. The forward seller recognizes gain or loss on the settlement date in an amount equal to the difference between the adjusted basis of the property delivered and the forward sales price.[14] The character of gain or loss depends on the nature of the underlying property in the forward seller's hands (for example, held as a capital asset by an individual investor).[15] The forward purchaser does not realize any gain or loss on the settlement date (even if the forward sales price is less than the spot price), but obtains basis in the property equal to the forward sales price.[16] The forward purchaser will not recognize gain or loss on the shares until a taxable disposition.

If the forward contract is cash-settled (in an amount equal to the difference between the spot price of the underlying property at settlement and the forward sales price), the forward seller does not recognize gain or loss on the underlying property (if actually held). The parties will recognize gain or loss, respectively, on the forward contract depending on whether a cash settlement payment is received or made.[17] The character of this gain or loss appears to depend on the nature of the underlying property in the party's hands.[18]

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to purchase the debentures); and Rev. Rul. 69-93, 1969-1 C.B. 139 (executory contract for the sale of land). *See also* David S. Miller, "Taxpayers' Ability to Avoid Tax Ownership: Current Law and Future Prospects," 51 *Tax Lawyer* 279, 305 (footnotes 101-104 and accompanying text) (Winter 1998); and Robert A. Rudnick and Michelle L. Petock, "Forward Sale Contracts: The IRS's Recent Attempts to View Code Sec. 1259 As a Trap for the Wary," 3 *Taxation of Financial Products* 19 (Summer 2002).

[11]*See* Alan L. Kennard, "Tax Issues Relating to Futures, Forward Contracts and Constructive Sales," *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings — 2002*, 553 *Practicing Law Institute (PLI)* 263 vol. 3 (2002).

[12]*See* David F. Levy, "Towards Equal Tax Treatment of Economically Equivalent Financial Instruments: Proposals for Taxing Prepaid Forward Contracts, Equity Swaps, and Certain Contingent Debt Instruments," 3 *Florida Tax Review* 471, 483-484 (1997); Kennard, *supra* note 11.

[13]*See* Treasury regulation section 1.1012-1(c)(1)-(8) for the identification rules applying to shares of stock and other securities.

[14]Section 1001(a). The taxation of forward contracts is summarized in Lewis R. Steinberg, "Using OTC Equity Derivatives for High-Net-Worth Individuals," in Frank J. Fabozzi, ed., *The Use of Derivatives in Tax Planning* (Frank J. Fabozzi Inc. 1998) at 225-226. The amount of gain or loss would also take into account transaction costs capitalized by the forward seller.

[15]Section 1221. *See* Kennard, *supra* note 11 at 4; Lewis R. Steinberg, "Taxation of Equity Derivatives," 554 *PLI* 849 vol. 17 (2002). Steinberg, *supra* note 14 at 226 (footnotes 55 and 42), notes that the law is unclear on whether the portion of the return on an "all in rate of return forward" (i.e., one that includes the dividend yield) is entirely capital in nature due to the dividend component, although industry practice for all in rate of return equity options is to treat the return as capital. The gain on physical settlement will be long-term if the securities have been held for more than one year on execution of the contract. Section 1222(3). The straddle rules can affect the holding period of positions that are part of a straddle. *See* Treasury regulation section 1.1092(b)-2T.

[16]Section 1012.

[17]If the forward seller owns the appreciated property sold forward, then any loss on the cash settlement of the forward contract may be deferred under the straddle rules of section 1092. *See* Steven M. Rosenthal and Liz R. Dyor, "Prepaid Forward Contracts and Equity Collars: Tax Traps and Opportunities," 2 *Journal of Taxation of Financial Products* 1 (Winter 2001). *See also* Bradford L. Ferguson, George R. Goodman, and Jonathon P. Biller, "The Latest Stock Hedging Regulations," *Tax Notes*, June 26, 1995, p. 1795; Richard J. Shapiro and Michael A. Meisler, "Working With the Straddle Rules of Section 1092 and 263(g)," in Fabozzi, *supra* note 14; Steinberg, *supra* note 14 at 240-248; John J. Ensminger, "Monetized Stock Positions, Index Instruments, and Other Frequently Ignored Straddles," 27 *Journal of Corporate Taxation* 3 (Autumn 2000).

[18]Section 1234A(1). The application of section 1234A to the scheduled cash settlement of a forward contract at maturity is not settled. *See* New York State Bar Association Tax Section (NYSBA), "Timing and Character Rules for Prepaid Forwards and Options," (March 26, 2001) at 33 (footnote 73) (citing NYSBA, "Report on Notional Principal Contract Character

**(Footnote 18 continued on next page.)**

**2. Monetization with prepaid forward sales.** A forward seller could use a forward contract to hedge and monetize appreciated stock by having the forward purchaser prepay the sales price upon the execution of the contract.[19] Although there was little direct authority, practitioners generally believed that prepayment of all or a portion of the forward sales price on the execution date did not disturb the conclusion that the forward sale remained open until settlement.[20] It is also believed that the taxation of prepaid forward contracts does not differ from the taxation of nonprepaid forward contracts.[21] The prepayment of a forward contract is made at a discount because there is a time-value-of-money element inherent in the pricing of forward sales (for example, if the forward sales price is $121 for delivery in two years and the discount rate is 10 percent compounded annually, the prepayment amount would be $100). Without a discount, the forward purchaser would have no incentive to prepay the forward contract, as the time value of money on the prepayment would be transferred to the forward seller. The prepayment is economically equivalent (on a pretax basis) to a zero coupon loan from the forward purchaser to the forward seller made on the execution date with interest accruing at the discount rate.[22] On the settlement date the forward seller can be viewed as repaying this loan, the proceeds of which the forward purchaser uses to acquire the property.[23] However, interest is not imputed on forward contracts even though the pricing reflects this time-value-of-money component.[24]

**3. VPFCs and similar forward sale arrangements.** One variation on the prepaid forward contract enables the forward seller to capture a portion of the future appreciation of the stock sold forward while contract-

and Timing Issues," (May 22, 1998)). *See also* Rosenthal and Dyor, *supra* note 17 (footnote 17) (noting that a cash settlement payment for a forward contract may result in a miscellaneous itemized deduction if section 1234A does not apply). Treasury recently proposed regulations for notional principal contracts with contingent, nonperiodic payments. Included in these regulations was proposed Treasury regulation section 1.1234A-1(c), which provides that a settlement payment on a forward contract "pursuant to the terms of the obligation" is treated as a termination payment for purposes of section 1234A.

[19]A forward purchaser will have basis in the prepaid forward contract in an amount equal to the upfront payment (rather than a basis of zero as with a non-prepaid forward contract). Gain or loss can also be recognized on the sale or exchange of the forward contract. *See* Kennard, *supra* note 11 at 4.

[20]*See Modesto Dry Yard, Inc. v. Comm'r*, 14 T.C. 374 (1950); *Bourne v. Comm'r*, 62 F.2d 648 (4th Cir. 1933). *See also* Rosenthal and Dyor, *supra* note 17 (text accompanying footnote 9); Levy *supra* note 12 at 483-484; Rudnick and Petock, *supra* note 10 at 21-23; NYSBA, "Timing and Character Rules . . . ," *supra* note 18. Practitioners' comfort with prepaid forwards has grown over time. *See* American Bar Association (ABA) Section of Taxation Financial Transactions Committee, "Report on Proposed Regulations Regarding Debt Instruments With Contingent Payments," 49 *Tax Lawyer* 195, 202 (Fall 1995) (describing the tax treatment of prepaid forwards as "unknown"); David A. Weisbach, 50 *Tax Law Review* 491, 498-499 (Summer 1995) (discussing possible alternatives for the taxation of prepaid forward contracts); David S. Miller, "Reconciling Policies and Practice in the Taxation of Financial Instruments," 77 *Taxes* 3 (March 1999) (noting that "[t]he correct genus of prepaid forward contracts (as a species of debt or of forward contract) remains in dispute and has yet to be the subject of definitive guidance" and citing NYSBA, "Report on Notional Principal Contract Character and Timing Issues" (May 22, 1998)).

[21]*See* NYSBA, "Timing and Character Rules . . . ," *supra* note 18 at 19, 43. The amount realized for purposes of determining gain or loss is the amount of the prepayment. Because the prepayment is discounted, this reduces gain on a physical settlement and can, *e.g.*, increase the forward seller's loss on a cash settlement in comparison to a nonprepaid forward contract. Steinberg, *supra* note 14 at 226 (footnote 55), concludes that section 1258 also should not operate to characterize a portion of the return on a prepaid forward as ordinary income because "substantially all the taxpayer's expected return is not attributable to the time value of money of the taxpayer's net investment in the transaction . . . ."

[22]The prepayment has been analyzed as avoiding an embedded loan from the forward seller to the forward purchaser. *See* Levy, *supra* note 8 at 7.

[23]If the transaction were documented as a non-prepaid forward sale of the stock and a loan secured by a pledge of the stock, then interest would accrue on the debt component. For authority regarding the separability of financial instruments, see, e.g., *Chock Full O' Nuts Corp. v. U.S.*, 453 F.2d 200 (2d Cir. 1971); Rev. Rul. 2003-97, 2003-34 IRB 1, *Doc 2003-17272 (11 original pages), 2003 TNT 142-20* (issuance of investment unit in issuer's stock as a separate forward contract and debt instrument is respected). Rev. Rul. 2003-97 is discussed in Mark H. Leeds, "Puzzling Indeed: When to Tax the Completed Puzzle Instead of the Pieces," *Tax Notes*, Sept. 29, 2003, p. 1697. *But see* FSA 200150012, *Doc 2001-30792 (23 original pages), 2001 TNT 242-28* (instrument documented as forward contract and debt not respected as debt).

[24]*See* Levy, *supra* note 8 at 9; Levy *supra* note 12 at 483-484; NYSBA, "Timing and Character Rules . . . ," *supra* note 18. Commentators generally agree that economically prepaid forwards should accrue interest, but note that prepaid forward contracts are not debt instruments that are subject to the original issue discount rules of sections 1271-1275. It has been suggested that the authority to require an interest imputation may reside in either section 7872 or section 446. *See* NYSBA, "Timing and Character Rules . . . ," *supra* note 18 at 13-15. For a contrary view, see Edward D. Kleinbard and Erika W. Nijenhuis, "Everything I Know About New Financial Products I Learned From DECS," 553 *PLI* 260, vol. 16 (2002). At one point in time, the IRS had opened a regulation project regarding prepaid financial instruments. *See* T.D. 8491, 58 Fed. Reg. 53125 (October 14, 1993); Juliann A. Martin, "IRS Attempting to Identify Time-Value-of-Money in Hybrids," *Tax Notes*, Mar. 20, 1995, p. 1767 (reporting that government officials did not agree on whether regulations were needed for the accrual of interest on prepaid forwards). More recently, the IRS announced that prepaid forward contracts would be addressed in guidance issued under section 446. *See Office of Tax Policy and Internal Revenue Service 2001 Priority Guidance Plan, Financial Institutions and Products*, item #6. Kleinbard and Nijenhuis, *supra* note 24 at 23 (footnote 70), report that it was possible that prepaid forwards would be included on the 2002 plan, citing *Office of Tax Policy and Internal Revenue Service 2002 Priority Guidance Plan, Financial Institutions and Products*, item #4.

ing for a set amount of exposure to downside risk. This type of agreement, known as a VPFC (or as a "variable share delivery contract" or some other moniker), commits the forward seller to deliver at settlement an amount of stock (or cash or other shares of equivalent value) that varies based on the value of such stock on the settlement date. For example, in exchange for an upfront payment, the forward seller might execute a VPFC with a cash settlement option on stock trading at $100 per share with a delivery date three years in the future. At settlement, if the stock is trading at a price lower than $100 per share, the forward seller will deliver 1 share or cash of equivalent value; if the stock is trading between $100 and $115 per share, the forward seller will deliver shares with a value of $100 or cash of equivalent value (that is, between 1 share and .87 shares); if the stock is trading for more than $115 per share, then the forward seller will deliver .87 shares or cash of equivalent value. Therefore, the forward seller is not subject to price decreases, retains 100 percent of the appreciation in a band of values, and retains 13 percent of the appreciation in excess of the band.[25]

VPFCs entered into by individuals use one of two structures.[26] For smaller positions, the forward seller will enter into an over-the-counter forward contract directly with a financial institution counterparty. The financial institution will then hedge its long position under the forward contract by entering into offsetting transactions such as short sales. The forward seller generally pledges the stock as security for the forward purchaser but retains the rights to receive dividends, to vote the pledged stock, and to settle the contract with cash or other shares.[27] For larger positions, for which it is more difficult for the financial institution to enter into offsetting hedges, the forward seller will often use a "trust structure." A trust structure permits an individual to indirectly issue instruments in the public capital markets.[28] Rather than a financial institution acting as the counterparty, a special purpose entity, such as a trust, is set up to enter into the forward purchase contracts with the forward seller. The trust, which is treated as a grantor trust, then issues instruments to investors who become the owners of the VPFCs.[29] The proceeds of the sale of the instruments are used by the trust to make a prepayment to the forward seller, pay expenses (for example, to the financial institution acting as the underwriter), and to acquire serially maturing zero coupon Treasuries that fund a coupon payment to the investors. This coupon is in excess of the dividends paid on the underlying stock, which enables investors to include low or non-dividend-paying growth stocks in their portfolios while earning a current return.

VPFCs are a "retail" version of a financial product exchangeable for common stock that is similar to a financial instrument used by corporate issuers to raise capital (such instruments are known as "debt exchangeable for common stock," hereinafter referred to as DECS).[30] DECS-type financial instruments are economically similar to VPFCs, but the corporate issuer may document these instruments as debt to obtain an interest deduction.[31] DECS may be issued in one of

[25]This example is drawn from NYSBA, "Comments on H.R. 846" (May 21, 1997), *Doc 97-15293 (54 pages), 97 TNT 103-11* (description of "variable delivery forward contract" in context of then-proposed section 1259).

[26]*See* David M. Schizer, "Frictions as a Constraint on Tax Planning," 101 *Columbia Law Review* 1312 at 1349-1356 (October 2001).

[27]As discussed herein, a VPFC has some indicia of a common law sale (e.g., the taxpayer receives cash and, at least temporarily, may not have legal title or possession of the pledged shares), but other characteristics of ownership (e.g., the right to dividends, voting rights, and the right to dispose of the pledged shares).

[28]Individuals, unlike corporations, generally are not registrants under the securities laws and therefore cannot use the public capital markets to sell stock forward. *See* Schizer, *supra* note 26 at 1354. Corporations do issue various types of instruments, described in the text immediately following, that are economically similar to VPFCs.

[29]*See* Louis S. Freeman, Matthew A. Stevens, and Victor Hollender, "Tax Consequences of Business and Investment-Driven Uses of Financial Products," 553 *PLI* 262, 292 vol. 16 (2002); Kleinbard and Nijenhuis, *supra* note 24 at 19 (discussing AJL PEPS Trust); and Donald D. Sung and Kevin Woodruff, "Synthetic Exchangeables and Convertibles: Structures and Selected Tax Issues," in Fabozzi, *supra* note 14 at 273-290.

[30]*See* Robert S. Bernstein, "Are VPFCs, Collars, and DECs Still Viable Hedging and Monetization Strategies?" 30 *Corporate Taxation* 2 (March/April 2003). DECS are known variously, depending on the financial institution involved and the particular features offered, as "DECS," "STAMPS," "ACES," "PEPS," or "PRIDES." For a general analysis of DECS-type financial instruments, see Kleinbard and Nijenhuis, *supra* note 24; Linda E. Carlisle, "Financial Products Exchangeable Into Common Stock: Tax Opportunities and Issues," 553 *PLI* 268 vol. 16 (2002); Freeman, Matthews, and Hollender, *supra* note 29; Jeffrey L. Rubinger, "Are the Cards Stacked Against the DECS?" 3 *Derivatives Report* 10 (June 2002); David M. Schizer, "Debt Exchangeable for Common Stock: Electivity and the Tax Treatment of Issuers and Holders," 1 *Derivatives Report* 7 (March 2000); and "Tax Issues Raised by Financial Products: Shorts Against the Box, Collars and Equity Derivatives," 13 *St. Johns Journal of Legal Commentary* 1 (Fall 1998). For a critical view of DECS-type financial instruments, see, e.g., Lee A. Sheppard, "Sand Castles of Debt Classification," *Tax Notes*, Aug. 31, 1998, p. 997. For an empirical analysis of considerations in issuing DECS, see William M. Gentry and David M. Schizer, "Frictions and Tax-Motivated Hedging: An Empirical Exploration of Publicly Traded Exchangeable Debt," 56 *National Tax Journal* 167 (March 2003).

[31]The IRS has proposed regulations that would result in capitalization of interest paid on DECS. *See* proposed Treasury regulation section 1.1092(d)-1(d), 6 *Federal Register* 4746 (January 18, 2001); NYSBA, "Report on Proposed 'Straddle' Regulations," (September 5, 2001) at 13-14. Individuals are generally less able than corporations to use an interest expense deduction due to the operation of the investment interest expense limitation of section 163(d) and other rules (e.g., the straddle rules of section 1092 and the interest and carrying charge capitalization rules of section 263(g)). *See* Steinberg, *supra* note 14 at 249. In 2001, the IRS proposed regulations that would broaden the application of section 263(g). *See* proposed Treasury regulation sections 1.263(g)-1 through -5, 6 *Federal Register* 4746 (January 18, 2001).

several forms, including a nonprepaid forward coupled with a loan, the proceeds from the repayment of which the forward purchaser must apply to the forward contract.[32] DECS do not require the issuer to pledge the underlying stock to the DECS investors and do not, therefore, raise the same common law sale questions as VPFCs, although section 1259 is potentially applicable to both DECS and VPFC transactions.[33]

### B. Forward Contracts Under Section 1259

In 1997, the enactment of section 1259 significantly curtailed the tax-deferral benefits under the common law of forward sales and other financial transactions used to hedge and monetize appreciated stock.[34] Section 1259(a)(1) provides that the "constructive sale" of an "appreciated financial position" (AFP) by the taxpayer is treated as if the taxpayer sold, assigned, or otherwise terminated the position for fair market value on the date of the constructive sale.[35] The taxpayer recognizes gain (but not loss), although the tax ownership of the AFP otherwise does not shift.[36] Adjustments regarding the position will be made to determine future gain or loss and the holding period recommences on the date of the constructive sale.[37] An AFP includes, subject to exceptions, any "position" regarding any appreciated stock, debt, or partnership interest.[38] The term "position" is defined in section 1259(b)(3) as "an interest, including a futures or forward contract, short sale or option."

Five categories of transactions can cause a constructive sale of an AFP if entered into by the taxpayer or a related person regarding the same or substantially identical property.[39] These transactions include (i) short sales, (ii) offsetting notional principal contracts, (iii) futures or forward contracts, (iv) acquiring the same or substantially identical property with respect to appreciated short sales, notional principal contracts, and futures or forward contracts, and (v) entry into one or more transactions or acquiring one or more positions having substantially the same effect as the foregoing, to the extent described in regulations to be promulgated.[40] For purposes of the section 1259(c)(1)(E)

[32]Schizer, *supra* note 30 at 13, notes that a "bifurcated" structure of a debt instrument and a forward contract is the typical approach. Another potential characterization of a DECS is as a contingent payment debt instrument. Kleinbard and Nijenhuis, *supra* note 24 at 29 *et seq.*, reject characterization of a DECS as a contingent payment debt instrument. For additional discussion of the various DECS structures, see Carlisle, *supra* note 30.

[33]Corporate issuers may also utilize a DECS-type arrangement regarding their own stock. These instruments, known as, e.g., "Upper DECS" or "Feline PRIDES," present additional tax issues under section 163(l), which issues were settled in part by the issuance of Rev. Rul. 2003-97. *See* Robert Willens, "Tax-Efficient Techniques for Disposing of an Appreciated Equity State Abound," 99 *Journal of Taxation* 3 (September 2003).

[34]P.L. 105-34, section 1001(a). Section 1259 generally was a response to media reports of a short-against-the-box transaction involving Estee Lauder's family that was perceived to be abusive. *See* David M. Schizer, "Hedging Under Section 1259," *Tax Notes*, July 20, 1998, p. 345, and articles cited therein. For a discussion of the proposals for change leading up to section 1259, see Daniel Shefter, "Tax Proposals on 'Short Against The Box' and Other Hedging Transactions," *Tax Notes*, Jan. 29, 1996, p. 581; NYSBA, "Comments on 'Short-Against-The-Box' Proposal" (March 1, 1996), *Doc 96-6515 (61 pages), 96 TNT 46-35*; Steven M. Surdell, "Analyzing Equity-Linked Debt Instruments After Reform Proposals," *Tax Notes*, June 10, 1996, p. 1525; Paul, "'Dispositions' . . .," *supra* note 3 ; and NYSBA, "Comments on H.R. 846," *supra* note 25. For a discussion of the impact of section 1259 on various hedging and monetization strategies, see Mark Kinsey and Richard Zack, "High-Net-Worth Individual Risk Management Solutions: Are OTC Derivatives Commodity Products or Proprietary Products?" 15 *Journal of Taxation of Financial Institutions* 30 (January/February 2002); Mary L. Harmon and Daniel P. Breen, "A Practical Guide to Equity Monetization," 554 *PLI* 253 vol. 16 (2002); Robert N. Gordon and Jan M. Rosen, *Wall Street Secrets for Tax-Efficient Investing*, chapter 5, (Bloomberg Press 2001); Steinberg, *supra* note 14; Andrea S. Kramer and William R. Pomierski, "New Constructive Sale Rules Make It Tougher to Avoid Tax on Built-In Gains," 25 *Estate Planning Journal* 7 (August/September 1998); Thomas J. Boczar, "Stock Concentration Risk Management After TRA '97," *Trusts and Estates* (March 1998); Simon D. Ulcickas, "Internal Revenue Code Section 1259: A Legitimate Foundation for Taxing Short Sales Against the Box or a Mere Makeover?" 39 *William and Mary Law Review* 1355 (March 1998); Peter L. Faber, Andrea S. Kramer, and William R. Pomierski, "The Ownership and Disposition of Property: New Rules for Old Problems," *Taxes* (December 1997); Robert Willens, "TRA '97 Closes Loopholes for Tax Deferral and Conversions of Gains Into Dividend Income," 87 *Journal of Taxation* 4 (October 1997); Schizer, *supra* note 36; and William M. Paul, "Constructive Sales Under New Section 1259," *Tax Notes*, Sept. 15, 1997, p. 1467. Section 1259 is generally discussed in Kramer, *supra* note 3 at chapter 32.

(Footnote 34 continued in next column.)

[35]Section 1259(e)(3) states: "If a taxpayer holds multiple positions in property, the determination of whether a specific transaction is a constructive sale and, if so, which appreciated financial position is deemed sold shall be made in the same manner as actual sales." This indicates that the identification rules of section 1012 continue to apply.

[36]S. Rep. No. 105-33, 105th Cong. 1st Sess. (1997) (Senate Report), at 123-124 ("Except as provided in Treasury regulations, a constructive sale would generally not be treated as a sale for other Code purposes"). Section 1259 therefore acts as a partial "mark-to-market" of the AFP on the date of the constructive sale.

[37]Section 1259(a)(2).

[38]Section 1259(b)(1). AFPs do not include straight debt that meets certain requirements, hedges of such straight debt, or positions that are marked to market. Section 1259(b)(2)(A)-(C). Other exceptions apply to certain short-term hedges. Section 1259(c)(3).

[39]A related person regarding a transaction is a person described in sections 267(b) or 707(b) that enters into the transaction with a view to circumventing the section 1259 constructive sale rules. Section 1259(c)(4).

[40]*See* section 1259(c)(1)(A)-(E). The statute contains a general grant of regulatory authority to issue regulations. Section 1259(f). The Conference Committee "urge[d] that the Treasury issue prompt guidance, including safe harbors, with respect to common transactions entered into by taxpayers."

(Footnote 40 continued on next page.)

"catch-all" provision, the legislative history described the other four transactions as eliminating "substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to [an] appreciated financial position."[41]

Section 1259(d)(1) defines a "forward contract" as "a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price."[42] The amount of property is not substantially fixed, according to the legislative history, if the amount deliverable under the forward contract is subject to "significant variation."[43] Although neither the statute nor the legislative history specify when an amount of property is not "substantially fixed" because it is subject to "significant variation," practitioners generally have believed that VPFCs avoid classification as a "forward contract" under section 1259 on account of the variable number of shares deliverable at settlement.[44]

### C. FSA 200111011

The legislative history to section 1259 demonstrates Congress's awareness of the use of open transaction treatment of the various hedging and monetization strategies to achieve the economic effect of a sale of appreciated stock without the realization of taxable gain.[45] The inclusion of forward contracts in section 1259(c)(1)(C) appeared to be implicit confirmation that executing such contracts, absent section 1259, would not result in a sale under common law principles.[46] As noted above, it has generally been believed that prepaying a forward contract did not alter this result. However, the consensus understanding of the common law was challenged when the IRS released Field Service Advice 200111011, *Doc 2001-7651 (9 original pages), 2001 TNT 53-64*.[47] In this FSA, the IRS concluded that a prepaid contractual arrangement resulted in a common law sale.

In FSA 200111011, the IRS analyzed a prepaid forward sale of a variable amount of appreciated stock in a corporation that was carried out through a trust structure.[48] Pursuant to a collateral agreement, the forward sellers pledged the maximum number of shares potentially deliverable on the settlement date and granted the trust a perfected security interest. The forward sellers also had the option of substituting U.S. govern-

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Conference Report on H.R. 2014, 105th Cong., 1st Sess., (1997) (Conference Report) at 209. To date, regulations have not been issued. The IRS has published four other revenue rulings under section 1259. *See* Rev. Rul. 2004-15, 2004-8 IRB 1, *Doc 2004-1748 (4 original pages), 2004 TNT 19-13* (open short sale with one broker not closed by transfer of shares borrowed from another broker; section 1259 transitional rules under the Tax Reform Act of 1997 still apply to properly identified open short sale); Rev. Rul. 2003-31, 2003-13 IRB 643, *Doc 2003-7988 (2 original pages), 2003 TNT 61-8* (changes to the terms of a short sale margin account will not cause consummation of a short sale or un-grandfather a short sale subject to section 1259 transitional rules under the Tax Reform Act of 1997); Rev. Rul. 2003-1, 2003-3 IRB 291, *Doc 2003-543 (5 original pages), 2003 TNT 4-9* (applying the "closed transaction exception" of section 1259(c)(3)(A)); and Rev. Rul. 2002-44, 2002-28 IRB 84, *Doc 2002-14853 (4 original pages), 2002 TNT 122-16* (gain under section 1259 is recognized on a profitable short sale on the trade date for the acquisition of the covering shares). *See also* LTR 200236045, *Doc 2002-20425 (3 original pages), 2002 TNT 174-53* (change in margin account interest rate does not cause a constructive sale or un-grandfather a short sale subject to the transitional rules under the Tax Reform Act of 1997); and LTR 200217039, *Doc 2002-10159 (3 original pages), 2002 TNT 82-40* (same).

[41]H.R. Rep. No. 105-148, 105th Cong., 2nd Sess., (1997) (House Report) at 442; Senate Report at 126; Staff of the Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997," (JCS-23-97) (Blue Book) at 177. This language appears to be adopted from Treasury's initial constructive sale proposal. This proposal targeted hedges that "substantially eliminate[d] risk of loss and opportunity for gain." *See* "Treasury's General Explanation of Administration Revenue Proposals," *Doc 96-8483 (153 pages), 96 TNT 56-9*. Congress ultimately enacted an alternative proposal (H.R. 846, Feb. 26, 1997) offered by Representative Kennelly that lists the four specific categories and a catch-all.

[42]Section 1259(c)(2) provides a narrow exception from the constructive sale rules for stock, debt, or partnership interests that are not section 453(f) marketable securities (i.e., not publicly traded) if the contract settles within one year of the date the contract is entered into. The Conference Report, note 40 *supra* at 208 states that "the conferees do not intend that an agreement that is not a contract for purposes of applicable contract law will be treated as a forward contract. Thus, contingencies to which the contract is subject will generally be taken into account." Section 1259(d)(1) was amended in 1998 retroactive to the original effective date of section 1259 to include cash-settled forward contracts. P.L. 105-206, section 6010(a)(2) (1998).

[43]Senate Report, *supra* note 36 at 125-126; Blue Book, *supra* note 41 at 178.

[44]For an analysis of issues arising under section 1259 regarding VPFCs and other similar financial transactions before Rev. Rul. 2003-7, see Dana L. Trier and Lucy W. Farr, "Constructive Sales Under Section 1259: The Best Is Yet to Come," 553 *PLI* 267 vol. 16 (2002); Kennard, *supra* note 11; James N. Calvin, "Hedging Stock Using Short Sales, Options, and Other Transactions," 19 *Journal of Taxation of Investments* 159 (Winter 2002); and Rudnick and Petock, *supra* note 10. For analysis of prepaid forward contracts before section 1259, see Levy, *supra* note 12.

[45]House Report, *supra* note 41 at 438; Senate Report, *supra* note 36 at 122.

[46]*Cf.* Blue Book, *supra* note 41 at 172-173 ("[t]axpayers may engage in other arrangements, such as . . . 'forward contracts,' . . . where the risk of loss and opportunity for gain with respect to property are shifted to another party (the "counterparty"). Under prior law, these arrangements did not result in the recognition of gain by the taxpayer.").

[47]FSAs are advice from the IRS National Office to the field on substantive and procedural issues. FSAs are nonbinding and are not included in Treasury regulation section 1.6662-4(d) as authorities relevant to the determination of whether "substantial authority" exists. In an interview, former IRS Chief Counsel B. John Williams Jr. stated that the IRS National Office would not be issuing FSAs in the future. *See* Jasper L. Cummings Jr. and Alan J.J. Swirski, "Interview With B. John Williams," 22 *American Bar Association Section of Taxation News Quarterly* 3 (Spring 2003).

[48]The transaction involved in this FSA has been identified as the AJL PEPS Trust, which was entered into by the owners of Amway Japan Limited. *See* Freeman, Stevens, and Hollender, *supra* note 29 at 294.

ment obligations in an amount equal to a percentage of the value of the pledged shares. The forward sellers remained entitled to dividends and other distributions and to vote on the pledged shares. At settlement, the forward sellers would settle the contract with the pledged shares, unless the trust instrument holders elected to receive the equivalent value of other stock of the corporation. The collateral agreement did not provide a cash settlement option for the trust instrument holders (other than for any fractional shares). The pledged shares constituted a minority interest and delivery of these shares would not divest the forward sellers of control of the corporation.

FSA 200111011 analyzed the timing of the forward sellers' recognition of gain under section 451.[49] In the field service advice, the IRS cited the Tax Court's opinion in *Hope v. Comm'r*, 55 T.C. 1020 (1971), *aff'd* 471 F.2d 738 (3rd Cir. 1973), *cert. denied* 414 U.S. 824 (1973), for the proposition that "a sale of stock was completed on the date that (1) title and possession of the certificates were transferred by the seller to the purchaser, and (2) the seller received payment in full." FSA 200111011 concluded that a sale occurred when the forward sellers received the purchase price and "de facto" transferred the shares to the instrument holders. The IRS pointed to (i) the absence of restrictions on use of the purchase price and (ii) the perfected security interest of the trust in the pledged shares. The IRS minimized the importance of the provisions of the collateral agreement that allowed substitute collateral because "[i]t seems highly unlikely that the [forward sellers] would elect to acquire and pledge U.S. Government securities . . . when they could more economically pledge shares on hand." The IRS concluded that "because the [forward sellers] were fairly limited in surrendering anything but the [pledged shares] as collateral, it appears that the [pledged shares] were transferred de facto to the instrument holders in Date 1."

The IRS then separately evaluated which party had the "benefits and burdens" of ownership of the pledged shares. The IRS cited *Grodt & McKay Realty, Inc. v. Comm'r*, 77 T.C. 1221 (1981), *aff'd* 426 F.2d 1391 (9th Cir. 1970), and *Lowe v. Comm'r*, 44 T.C. 363 (1965), for the proposition that a sale occurs for federal tax purposes when "the benefits and burdens of ownership are transferred from the seller to the purchaser." This inquiry involves a facts-and-circumstances evaluation.[50] The IRS listed the following factors, not all of which had to be present, to be taken into account:

> "(1) Whether the sale price was fixed; (2) whether a significant amount of the agreed price has been paid; (3) the descriptive terms used in the agreement; (4) whether an effective date has been agreed upon fixing a specific time for recognition of the rights and obligations of the parties; (5) whether the purchaser bears the risk of loss and opportunity for gain; (6) whether legal title has passed; (7) the intention of the parties; and (8) the probability that the transaction would be consummated." *See Grodt & McKay Realty, supra; Maher v. Comm'r*, 55 T.C. 441, *aff'd in part and remanded in part*, 469 F.2d 225 (8th Cir. 1972), *nonacq.* 1977-2 CB 2.

In FSA 200111011, the IRS concluded that the benefits and burdens of ownership of the pledged shares had passed to the instrument holders. The IRS said that: (i) the sale price was fixed; (ii) the proceeds were received without restrictions as to use; (iii) the parties called the transaction a sale/purchase; (iv) the execution date and settlement date were fixed in time; (v) the instrument holders had the greater opportunity for gain and risk of loss under the formula used to determine the number of shares deliverable at settlement; and (vi) the parties intended a sale. The IRS discounted the fact that title did not pass because the instrument holders had a first-priority perfected security interest and a first lien on the pledged shares. The IRS also discounted the right to substitute collateral. According to the IRS, the sale of stock was likely to occur because the economics of posting government securities as substitute collateral made it unlikely the forward sellers would do so and the forward sellers could not cash-settle the contract. The IRS believed that the transaction was likely to close without either party walking away from the deal due to the pledge of the securities to the trust and because the instrument holders did not need to take any further steps under the contract to receive the pledged shares at settlement. Finally, the IRS downplayed the retention of the rights to dividends and distributions and voting rights because the shares to be delivered were a minority interest (so the forward sellers would continue to maintain control after the transaction) and the quarterly distributions to be provided to the instrument holders were greater than the projected dividends on the pledged shares.

## II. Rev. Rul. 2003-7

The discussion of tax ownership of securities under the common law in FSA 200111011 appeared incorrect to many commentators, who questioned whether the IRS was applying the relevant tax ownership test.[51] The

[49]Section 451 governs the timing of the reporting of income.

[50]*See Baird v. Comm'r*, 68 T.C. 115 (1977).

[51]For a detailed criticism of the analysis in FSA 200111011, see Rudnick and Petock, *supra* note 10. *See also* Kevin M. Keyes, *Federal Taxation of Financial Instruments and Transactions*, Warren, Gorham and Lamont (1997) par. 3.07[5] at 107 (footnote 604.1) (describing FSA 200111011 as "seriously flawed" and in conflict with Rev. Rul. 69-93, 1969-1 C.B. 139, General Counsel Memorandum 36957 (December 20, 1976), and FSA 199940007, *Doc 1999-32427 (16 original pages), 1999 TNT 196-50*; Kramer, *supra* note 3 section 60.04[F] at 21-22 (describing the reasoning and conclusion in FSA 200111011 as "questionable"); Freeman, Stevens, and Hollender, *supra* note 29 at 297 (describing the conclusion as "highly dubious"); Jeffrey L. Rubinger, "Recent FSAs May Provide Guidance on Taxation of Popular Hedging/Monetization Transaction," 97 *Journal of Taxation* 2 (August 2002). In an earlier FSA, the IRS had

**(Footnote 51 continued on next page.)**

well-supported arguments of these commentators no doubt contributed to the IRS's decision to publish guidance on the federal income tax treatment of VPFC transactions. In Rev. Rul. 2003-7, the IRS formally addressed the question of whether an actual or a constructive sale occurred on the execution of a VPFC.[52] The IRS concluded, based on the terms of the contract and the conditions under which the contract was entered into, that a sale did not occur under either common law principles or under section 1259.

### A. Facts of Rev. Rul. 2003-7

Taxpayer T (T) owns appreciated stock in publicly traded Company Y (Y). The stock is trading at $20 per share when T enters into a contract with Investment Bank (IB) on Date 1 (Execution Date). Under the contract, T receives an upfront payment of cash from IB in exchange for T's agreement to deliver an amount of Y stock determined under a formula on Date 2, which is three years in the future (Exchange Date). The formula requires delivery of (i) 100 shares if Y stock trades at less than $20 on the Exchange Date, (ii) an amount of Y Stock with a value of $2,000 if Y Stock is trading at $20 per share to $25 per share on the Exchange Date, and (iii) 80 shares if Y stock is trading at more than $25 per share on the Exchange Date. Under the contract, T must secure his obligation by pledging 100 shares (the maximum number of shares potentially deliverable on the Exchange Date) of Y stock to IB, which shares are deposited with a third-party trustee that is unrelated to IB. However, T does not relinquish the right to dividends paid on the pledged Y stock or the right to vote the pledged Y stock. Moreover, T has the "unrestricted legal right" to settle the contract on the Exchange Date with any of the pledged Y stock, an amount of cash with an equivalent value, or other stock with an equivalent value. On the Execution Date, T intends to deliver the pledged Y stock on the Exchange Date, but T is not "economically compelled" to deliver the pledged Y stock.

### B. IRS Analysis

In ruling that a sale or exchange did not occur on the Execution Date, the IRS divided its analysis into two parts. First, the IRS analyzed whether an actual sale or exchange within the meaning of section 1001 had occurred. Second, the IRS analyzed whether a constructive sale under section 1259 had occurred.

**1. Section 1001.** Under section 1001, a taxpayer generally realizes and recognizes gain or loss if there is a sale or exchange of property. In Rev. Rul. 2003-7, the IRS cited *Torres v. Comm'r*, 88 T.C. 702, 721 (1987), as authority for the proposition that the relevant factors and weighting of factors in the analysis of whether a sale has occurred must be determined in light of the nature of the property. A line of cases addresses the tax ownership of securities, which are a type of property that is fungible, and the IRS based its analysis in the revenue ruling on these cases.

There is authority holding that the transfer of legal title and possession of securities does not constitute a sale or exchange where the taxpayer retains significant rights regarding the securities. On this point, the IRS cited *Cruttenden v. U.S.*, 644 F.2d 1368 (9th Cir. 1981), *Lorch v. Comm'r*, 70 T.C. 674 (1978), *aff'd* 605 F.2d 657 (2d Cir. 1979), *cert. denied* 444 U.S. 1076 (1980), and *Miami National Bank v. Comm'r*, 67 T.C. 793 (1977), cases in which the owner transferred securities to a brokerage firm, which held the securities in a subordination account. This arrangement permitted the brokerage firm to meet net capital requirements imposed by a stock exchange. The securities in the subordination account were available to satisfy the claims of the brokerage firm's general creditors, but the subordination agreement did not require the owner to relinquish voting rights or rights to dividends. The owner also had the right to substitute cash or other securities as collateral. On account of the retained rights regarding the stock, the courts have held that the taxpayer and not the brokerage firm was the tax owner of the shares in the subordination account. The IRS stated in Rev. Rul. 2003-7 that these cases "indicate that a transfer of actual possession of stock or securities and legal title may not itself be sufficient to constitute a transfer of beneficial ownership when the transferor retains the unrestricted right and ability to reacquire the securities."

There is also authority that a mere intent to deliver securities to close a transaction does not constitute a sale or exchange of those securities. The IRS cited *Richardson v. Comm'r*, 121 F.2d 1 (2d Cir. 1941), and *Klinger v. Comm'r*, 1949 PH T.C. Memo. par. 49,132, two cases involving short sales of stock. The courts have held that covering purchases intended to close a short sale of stock do not effect a sale of the shorted stock when the facts indicate that the taxpayer has not entered into an agreement or understanding with the

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reached the opposite conclusion on similar facts. *See* FSA 199940007, *Doc 1999-32427 (16 original pages), 1999 TNT 196-50* (concluding that there was not a common law sale on execution of a similar contract). FSA 200130010, *Doc 2001-20230 (7 original pages), 2001 TNT 146-24*, modified FSA 199940007 but did not change the conclusion on the current sale issue. *See also* FSA 200131015, *Doc 2001-20775 (21 original pages), 2001 TNT 151-15* (no current sale). There are distinctions between the facts in the FSAs (e.g., the taxpayer in FSA 200111011 did not have a cash settlement right). FSA 200111011 did not discuss the statutory constructive sale rules.

[52]In *Bobby G. Stevenson, et ux. v. Comm'r*, Docket No. 13449-02, the IRS reportedly challenged a retail VPFC transaction under the common law. *See* Lee A. Sheppard, "IRS Pursues Individual Constructive Sales Using Equity-Linked Securities," *Tax Notes*, Sept. 30, 2002, p. 1797; "Equity Pros Cast Nervous Eyes on U.S. Tax Trial," *Derivatives Week* (November 25, 2002). The Stevensons filed a Tax Court petition in August 2002, that indicates that the VPFC is a "STRYPES." For a discussion of STRYPES (Structured Yield Product Exchangeable for Stock), which is marketed by Merrill Lynch, see Dawn Kawamato, "How CEOs Can Cash in Quietly," *CNETnews.com* (February 8, 1998) (Web site last checked August 2003). The IRS did not, it appears, raise a section 1259 issue and according to the petition, the number of shares deliverable at settlement could have varied as much as 37 percent. The parties filed a stipulation of settled issues in favor of the Stevensons regarding the STRYPES issue on July 18, 2003.

lender regarding delivery of particular shares and do not otherwise suggest that the taxpayer has "placed himself in a position in which he was not entitled to treat the purchased shares as long stock and sell them for his own account . . . ." The courts have reasoned that the taxpayer's ability to dispose of the covering shares until actual delivery of such shares to close the short sale was not restricted (that is, the transaction remained open). Therefore, it is the actual delivery of the shares that controls whether a sale has occurred. The IRS cited *Richardson* for the proposition that "even if the shareholder intends to complete a sale by delivering identified stock, that intent alone does not cause a transaction to be deemed a sale, as long as the taxpayer retains the right to determine whether the identified stock will in fact be delivered."

The IRS then discussed the *Hope* case (which had been in part the basis for the IRS's different conclusions in FSA 200111011). In *Hope* the taxpayer transferred legal title and possession of stock to an investment bank without restriction as to use and received the sale proceeds in exchange. The taxpayer argued that a sale of the stock was not completed in the year of the transfer because he sought a rescission of the sale. The Tax Court decided that a sale had in fact occurred in the year of transfer, noting that the taxpayer had received the sale proceeds when he transferred the stock "without any restrictions on his use or disposition of those funds."

In Rev. Rul. 2003-7, T also transferred title and possession of stock in exchange for an upfront payment without restrictions as to use. However, the transfer was to a third-party trustee and not the purchaser, T retained dividend and voting rights, and T could reacquire the Y stock on the Exchange Date by tendering cash or other property of equivalent value. According to the IRS, these factors distinguished the VPFC from the *Hope* case. Therefore, according to the IRS, the contract did not result in a common law sale or exchange of the pledged Y stock under section 1001(a) on the Execution Date. However, in a closing paragraph, the IRS stated that:

> A different outcome may be warranted if a shareholder is under any legal restraint or requirement or under any economic compulsion to deliver pledged shares rather than to exercise a right to deliver cash or other shares. For example, restrictions placed upon a shareholder's right to own pledged common stock after the Exchange Date, or an expectation that a shareholder will lack sufficient resources to exercise the right to deliver cash or shares other than pledged shares, would be significant factors to be weighed in determining whether a sale has occurred.

**2. Section 1259.** Having concluded that there was not a common law sale of the pledged Y stock on the Execution Date, the IRS next turned to the potential application of section 1259. The IRS summarily ruled that the variation in the number of shares, from 80 to 100, constituted a "significant variation." Therefore, the VPFC was not a section 1259(d)(1) forward contract that resulted in a constructive sale of the pledged stock under section 1259(c)(1)(C).

## III. Analysis of Rev. Rul. 2003-7

The IRS's interpretations of the common law and section 1259(c)(1)(C) in Rev. Rul. 2003-7 conform in large part to practitioners' general expectations regarding the applicability of the actual and constructive sale rules to VPFCs of publicly traded securities.[53] The revenue ruling provides a road map for VPFCs that the IRS will not challenge, but also raises other questions under the common law and section 1259. First, the revenue ruling analyzes the tax ownership of the securities applying generally accepted common law principles. However, the introduction of additional elements for taxpayers to evaluate complicates the analysis of whether a particular contract causes — or a particular taxpayer has made — a sale of the securities. Second, the IRS's discussion of section 1259 is brief and the ruling that a VPFC is not a "forward contract" is reached with little discussion and no useful analysis. This holding is narrowly tailored to address only one issue — whether a VPFC is a forward contract under section 1259(d)(1) for purposes of section 1259(c)(1)(C). Nevertheless, practitioners will focus closely on the facts of the revenue ruling to determine the implications, if any, for VPFCs and economically equivalent financial transactions under other provisions of section 1259.

### A. Common Law Sale Principles

**1. Tax ownership of securities.** Rev. Rul. 2003-7 presents an analysis of the common law ownership of publicly traded securities that is a significant improvement over the IRS's discussion in FSA 200111011. In the revenue ruling, the IRS abandons the line of reasoning in the FSA and confirms that the tax ownership of publicly traded securities is determined by analyzing factors that are not relevant in the context of tax ownership of other types of property.

[53]Numerous articles discussing Rev. Rul. 2003-7 have already been published. *See* Stephen H. Douglas, "Navigating Section 1259: Lessons (And Some Relief) From Rev. Rul. 2003-7," 14 *Journal of International Taxation* 8 (August 2003); Willens, *supra* note 33; "Guidance on Stock-for-Cash Pledge Leaves Unanswered Questions, Practitioners Say," *Daily Tax Report* (June 23, 2003); Richard M. Lipton, "New IRS Ruling Sanctions Some Variable Prepaid Forward Contracts," 6 *Journal of Passthrough Entities* 3 (May/June 2003); Jasper L. Cummings Jr., "Pre-Paid Forward Contract Not Treated as Constructive Sale," 1 *Cummings Corporate Tax Insights* 1 (April 8, 2003); Robert Willens, "'Monetization' of Appreciated Stock Does Not Produce Actual or Constructive Sale," *DTR*, Mar. 17, 2003; David H. Shapiro, "Taxpayer-Friendly Result in Rev. Rul. 2003-7 May Create a False Sense of Security," *Tax Notes*, Feb. 24, 2003, p. 1265; "Ruling on Pledge of Stock for Cash Creates a Conservative Road Map, Treasury Aide Says," *DTR*, Feb. 19, 2003; John F. Prusiecki, "Interesting Implications of Revenue Ruling 2003-7," *Tax Notes*, Feb. 3, 2003, p. 775; and Lee A. Sheppard, "No Constructive Sale in a DECS Transaction," *Tax Notes*, Feb. 3, 2003, p. 649. The IRS also cited Rev. Rul. 2003-7 in TAM 200341005, *Doc 2003-22255 (16 original pages), 2003 TNT 198-11* (concluding that a trust structure variable prepaid forward sale did not result in a common law sale of the underlying shares).

There is extensive case law addressing whether a sale or exchange of property has occurred because tax ownership is and has been important in numerous contexts (for example, entitlement to depreciation, investment tax credits, etc.). The nature of the property at issue is a relevant consideration in evaluating tax ownership, a point the IRS acknowledged in Rev. Rul. 2003-7 by citing *Torres*. An important tax distinction in the nature of property is fungibility: Publicly traded securities are fungible because one share is generally no different than any other, whereas other types of property, such as real property, are generally nonfungible because a particular property is unique.[54] Fungibility makes it possible to borrow and sell short publicly traded securities, so there can be multiple taxpayers with a long position with respect to a share of stock; however, there is still only one tax owner of the share.[55] For this reason, the courts have developed different methods of analysis of tax ownership for fungible and nonfungible property. As discussed below, the tax ownership of securities is based on certain indicia of ownership that are not generally present with nonfungible property or even with other fungible property, such as commodities.

In FSA 200111011, the IRS employed a benefits and burdens analysis developed primarily in cases that involved the tax ownership of nonfungible property in concluding that a common law sale of securities had occurred.[56] This analysis focuses on determining who is entitled to the economic benefits and who bears the economic burdens of the property. Although the IRS did cite two cases in FSA 200111011, *Lowe* and *Maher*, involving the tax ownership of stock in closely held corporations in which this benefits and burdens analysis was employed, the IRS did not cite numerous other authorities involving the tax ownership of securities that have taken a fundamentally different approach. Under this precedent, tax ownership is based on a formalistic analysis that generally takes into account four significant rights: (i) the right to dividends and other distributions; (ii) the right to vote; (iii) the right to dispose of the stock; and (iv) the opportunity for gain and the risk of loss.[57] It is the presence or absence of these factors that generally controls rather than the benefits and burdens test applied to nonfungible property.

In Rev. Rul. 2003-7, the first three of these rights were kept by the forward seller: The contract permitted the forward seller to retain dividends, to vote the pledged shares, and to dispose of the pledged shares (cash-settle or deliver other property).[58] Although the forward seller in Rev. Rul. 2003-7 transferred all of the risk of loss to the forward purchaser, he did not relinquish all of the opportunity for gain: If the stock traded above $20 per share on the settlement date then the forward seller retained 100 percent of the first 25 percent of appreciation and 20 percent of any appreciation above that. The IRS concluded, based on the subordination agreement and short sale cases, that there was not a current sale of the pledged stock.[59] The IRS did not cite either *Lowe* or *Maher* from FSA 200111011 in Rev. Rul. 2003-7 or otherwise attempt to reconcile these cases with the subordination agreement and short sale cases. The IRS also did not rely on or even cite two cases (*Modesto Dry Yard* and *Bourne*) that addressed the taxation of forward contracts that were in part prepaid.[60] By exclusively relying on case law that analyzed the tax ownership of securities in light of the factors listed above, the IRS appears to have conceded that the benefits and burdens test primarily employed in cases involving nonfungible property is not applicable to the tax ownership of publicly traded securities.

The IRS did discuss one case from FSA 200111011 in Rev. Rul. 2003-7. The IRS distinguished the *Hope* case, which is factually inapposite, based on the forward seller's retention of voting rights and the right to dividends. Once again, the IRS relied on two factors that are important to the tax ownership of fungible property under the common law precedents. However, the IRS

[54]*See Richardson v. Shaw*, 209 U.S. 365 (1908) (shares of a particular issue of stock in a company are not different in kind or value from other shares of the same issue of stock in that company). For a discussion of tax ownership of securities, see Edward D. Kleinbard, "Risky and Riskless Positions in Securities," 71 *Taxes* 783 (1993) (contrasting riskless tax ownership of a short-against-the-box with risky nonownership of a securities loan). For a discussion of tax ownership of nonfungible property and related issues, see Faber, Kramer, and Pomierski, *supra* note 34.

[55]*See* Kleinbard, *supra* note 54 at 787. Section 1058 addresses the taxation of securities lending transactions.

[56]Rudnick and Petock, *supra* note 10 at 30 (footnote 28) note that the factors in the FSA may be relevant to whether the parties intended a sale of the securities, but are less relevant to the timing of the sale.

[57]*See Miami National Bank, supra*; Rudnick and Petock, *supra* note 10 at 24. *See also* Kleinbard, *supra* note 54 at 786-793 (arguing that the right to dispose is the critical right regarding the tax ownership of securities).

[58]A forward seller should be able to transfer the economic value of dividends to the forward purchaser without relinquishing the right to the actual dividends under case law that treats a dividend equivalent payment as an adjustment to the forward purchase price and not a payment of the dividends. *See Joseph L. O'Brien Co. v. Comm'r*, 301 F.2d 813, *aff'g* 35 T.C. 750 (1961); *Max Viault*, 36 B.T.A. 430 (1937). Transferring the right to vote shares alone should not shift tax ownership. *See* Willens, *supra* note 33 at J-1 (citing Rev. Rul. 71-262, 1971-1 C.B. 110, and Rev. Rul. 75-95, 1975-1 C.B. 114, for the conclusion that a taxpayer can transfer shares to a voting trust without tax ownership being divested).

[59]It appears that a critical distinction from FSA 200111011 is that the taxpayer in Rev. Rul. 2003-7 had the right to cash-settle the contract (i.e., to dispose of the shares). *See* Shapiro, *supra* note 53 at 1267-1268 (noting that the right to cash-settle (versus delivering other shares) has been considered particularly important to avoiding a common law sale). *Cf.* Rubinger, *supra* note 51 at 116.

[60]The IRS may not have referenced these prepaid forward contract cases because the properties at issue in those cases were, respectively, raisins (which, as a commodity, appear to have been fungible) and real estate, rather than securities. The exposition of the law in Rev. Rul. 2003-7 references the short sale cases for the open transaction treatment of the forward sale.

added an additional distinction that is less compelling: The IRS specified that the taxpayer transferred title and possession of the pledged shares to a third-party trustee and not to the investment bank counterparty. The identity of the collateral agent should not be dispositive in analyzing the tax ownership of publicly traded securities when the right to dispose of the shares is not transferred and use of an affiliate of the forward purchaser as the collateral agent, rather than an unrelated third-party trust, should not necessarily limit the revenue ruling's application.[61]

**2. 'Unrestricted legal rights' and 'economic compulsion.'** Rev. Rul. 2003-7 contains a plain warning to taxpayers that the failure to have an "unrestricted legal right" to substitute cash or other shares or the presence of an "economic compulsion" to deliver the pledged shares may affect the conclusion that the taxpayer remains the common law tax owner of the securities. These factors, which the IRS assumed away in Rev. Rul. 2003-7, introduce an additional facts-and-circumstances component to the analysis of whether entry into a particular VPFC by a particular taxpayer does or does not conform to the transaction approved in the revenue ruling.

**a. Unrestricted legal rights.** Rev. Rul. 2003-7 states that "any legal restraint or requirement" requiring delivery of the pledged shares rather than other property to settle the contract can affect the common law analysis. This factor appears to apply broadly because, according to the revenue ruling, "any" legal restraint or requirement is potentially relevant. Thus, such a restraint apparently could be imposed by contract, regulatory law or otherwise. Presumably the IRS's purpose for the "unrestricted legal right" factor is to prevent taxpayers from entering into VPFCs in which the right to settle the contract with cash or other property, rather than the pledged shares, is illusory. An example of this, according to the IRS, is "restrictions placed upon a shareholder's right to own pledged common stock after the Exchange Date," which would be a "significant factor" to be taken into account in determining whether there was a common law sale.[62] However, the example is not very helpful because it does not illustrate how such restrictions would apply. Furthermore, even if a restriction is relevant, the example indicates that it would be a "significant" — but apparently not dispositive — factor to be taken into account.[63]

TAM 200341005 gave the IRS the opportunity to analyze a "live" case to determine whether a taxpayer had an unrestricted legal right to reacquire pledged shares in a VPFC transaction.[64] The TAM applied the common law analysis from Rev. Rul. 2003-7 to conclude that the execution of the VPFC was not a completed sale of stock. The TAM states that the taxpayer indirectly entered into a forward sale of a corporation's stock to dilute his ownership for accounting purposes. As of the execution date, the taxpayer would not be able to cause the exercise of a right to cash-settle the contract on the exchange date. The taxpayer would be able to reacquire shares only in an amount that would not cause the taxpayer to own stock in excess of a specified percentage of the corporation's outstanding stock on the exchange date. However, on the day following the execution date, the corporation made an offering of additional shares that increased the total number of outstanding shares. This offering negated the percentage restriction on the taxpayer's ability to own shares in the corporation on the exchange date. Based on the proximity in time of the execution of the forward contract and the offering, the IRS ruled that the taxpayer "effectively" did have an unrestricted legal right to cash-settle the contract.

TAM 200341005 illustrates an example of a restriction on the taxpayer's ability to own shares after the exchange date that was in existence on the execution date. Although the TAM does not indicate the source of the taxpayer's restriction (noting only that the restriction related to accounting rules), it makes clear that the common law sale results will not vary from Rev. Rul. 2003-7 when other events effectively negate such a restriction.[65]

**b. Economic compulsion.** Rev. Rul. 2003-7 likewise is vague as to the meaning of "economic compulsion." The example of economic compulsion says only that "an expectation that a shareholder will lack sufficient resources to exercise the right to deliver cash or shares other than the pledged shares" would be a "significant

[61]This conclusion is further supported by one of the revenue ruling's coauthors, who deemphasized the use of a third-party trustee to hold the pledged securities following the publication of Rev. Rul. 2003-7. *See* Sheryl Stratton, "Dilating Derivatives Guidance Requires Industry Input IRS Says," *Tax Notes*, June 2, 2003, p. 1313 (reporting comments of Christina Morrison, IRS associate chief counsel (Financial Institutions and Products)).

[62]Shapiro, *supra* note 53 at 1267, notes that Rev. Rul. 2003-7 leaves open the possibility that the taxpayer must only have the unrestricted legal right to deliver cash or other property to settle the contract as of the date of the settlement and not during the term of the forward contract. He further notes that this would be inconsistent with *Miami National Bank* and the other subordination agreement cases, which permitted the taxpayer to substitute collateral at any time under the agreement.

[63]The concept of an "unrestricted legal right" also appeared in a subsequent revenue ruling published in 2003. This analysis may be relevant to interpreting Rev. Rul. 2003-7 because it dealt with a similar forward sale of stock. In Rev. Rul. 2003-97, the IRS ruled on the deductibility of interest on a five-year debt instrument issued in a unit with a forward contract to buy the issuer's stock. Similar to a VPFC, the forward contract obligates the purchaser to buy a variable amount of shares based on the trading price of the stock on the settlement date. One case cited in Rev. Rul. 2003-97 that appeared to involve a limit on "unrestricted legal rights" involved a shareholders agreement. *See Universal Castings Corp. v. Comm'r*, 37 T.C. 107 (1961), *aff'd* 303 F.2d 620 (7th Cir. 1962).

[64]The TAM did not address section 1259, although the facts indicated that the amount of stock to be delivered under the contract would vary "significantly."

[65]The TAM relied on the closeness in time of the two events (execution of the VPFC and the stock offering). However, the TAM did not base the conclusion on the event being part of an interrelated or integrated plan.

factor in the common law sale analysis."[66] This example does not elucidate economic compulsion because it does not explain how one determines if this factor is present.[67] Presumably a taxpayer that has no such subjective expectation will not be at risk, even if it subsequently develops that, objectively, the taxpayer had insufficient resources to settle the contract with property other than the pledged shares.[68] However, even if the taxpayer has an expectation of insufficient resources, this again would only be a "significant" factor in the common law sale analysis.[69] The absence of an explanation of economic compulsion makes it difficult to extrapolate from the example.[70]

**c. Time for testing.** Rev. Rul. 2003-7 also fails to explain when one is to test for unrestricted legal rights and economic compulsion. The revenue ruling does not explicitly mandate that the taxpayer test for the right to reacquire the pledged stock or economic compulsion as of the execution date, although it would be logical that the execution date is the appropriate time to test because the revenue ruling examines whether the execution of the contract results in a common law sale.[71]

The IRS appears to have confirmed that the execution date is the relevant point in time to test for both unrestricted legal rights and economic compulsion.[72]

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[66]The importance of the economic compulsion factor is not settled. *See* "Guidance on Stock-for-Cash Pledge . . . ," *supra* note 53 at G-1 (reporting disagreement between an IRS official and a Treasury official over whether "economic compulsion" was a "throw-away" term or the "linchpin of the ruling"). One commentator has concluded that economic compulsion will rarely be a factor. *See* Lipton, *supra* note 53 at 32. Leeds, *supra* note 23 at 1703, notes that there is not a completed sale in a short-against-the-box transaction "even if the short seller would be considered to be under an economic compulsion to sell stock 'held in the box.'"

[67]In Rev. Rul. 2003-97, the IRS explained in the context of Feline PRIDES that the existence of economic compulsion to exercise a right or option, based on all of the facts and circumstances, is relevant to determine the tax consequences of a transaction. The IRS cited Rev. Rul. 2003-7 and a number of cases that reference the existence or absence of economic compulsion as authority for this conclusion. *See American Realty Trust v. U.S.*, 498 F.2d 1194, 1199 (4th Cir. 1974) (exercise of repurchase option due to availability of favorable financing, not economic compulsion); *Roberts v. Comm'r*, 71 T.C. 311, 323 (1978), *aff'd* 643 F.2d 654 (9th Cir. 1981) (installment sale of shares to trust respected despite subsequent sale by transferees); and *Comtel Corp. v. Comm'r*, 45 T.C. 294, 307 (1965), *aff'd* 376 F.2d 791, 796 (2d Cir. 1967) (exercise of repurchase option to avoid loss on a transaction and indemnity indicate economic compulsion). For a discussion of other economic compulsion cases in the sale-leaseback context, see Philip J. Harmelink and Nancy E. Shurtz, "Sale-Leaseback Transactions Involving Real Estate: A Proposal for Defined Tax Rules," 55 *Southern California Law Review* 833, 840-841 (May 1982) (citing cases); Stephan L. Hodge, "Sale-Leasebacks: A Search for Economic Substance," 61 *Indiana Law Journal* 721, 724-725 (Fall 1986). The IRS also compared Rev. Rul. 82-150, 1982-2 C.B. 110 (purchaser that paid 70,000x for an option exercisable for 30,000x to acquire stock in a corporation with assets of 100,000x treated as the tax owner under substance-over-form principles). Query whether the potential importation of cases involving economic compulsion to exercise options suggests that a VPFC should be analyzed as an option collar transaction as described below in the context of section 1259.

[68]The IRS has used different tests in other rulings involving financial transactions. In Rev. Rul. 85-87, 1985-1 C.B. 268, the IRS applied a "substantial likelihood" test to an option transaction under the wash sale rules of section 1091. The IRS concluded that a taxpayer who wrote an in-the-money put option on stock the day after the sale of the same stock at a loss was treated as acquiring the stock within the 30-day wash sale period following the sale. The market price of the stock was "substantially less" than the exercise price of the put, which was exercisable by the holder within 60 days of the writing of the option. The IRS also looked at the amount of the premium, the past volatility of the stock, and "other objective factors" to conclude that there was "no substantial likelihood" that the put would not be exercised. Adverting to substance-over-form principles, the IRS held that the "put option" was "in substance a contract to acquire stock" for

**(Footnote 68 continued in next column.)**

purposes of the wash sale rules. *See also* Rev. Rul. 83-98, 1983-2 C.B. 40 (adjustable rate-convertible note treated as equity not debt due to the very "high probability" that the instruments will be converted into stock).

[69]Relevant factors might include (i) the size of the VPFC relative to the number of shares traded or the taxpayer's net worth and (ii) the size of the VPFC relative to the total shares held by the taxpayer and the relative tax bases of the pledged shares to the remaining shares. *See* Shapiro, *supra* note 53 at 1269-1270.

[70]In Miller, *supra* note 10 at 323, the author distinguishes the American-style option giving rise to constructive ownership in Rev. Rul. 82-150 from a similar European-style call option or a cash-settled call option, which he equates with prepaid forwards. "European-style" options are only exercisable on a particular date. "American-style" options are exercisable on any date. *See* The Options Clearing Corporation, "Characteristics and Risks of Standardized Options," available at http://www.optionsclearing.com. Miller notes that, unlike American-style options, there is counterparty risk with the European-style option. *See also* Levy, *supra* note 8 at 12-13. Query whether Rev. Rul. 2003-7 should have distinguished Rev. Rul. 82-150 based on the distinction between an American-style option and a cash-settled, European-style option. Query also the effect of the forward seller's pledge of the stock and/or the collateral agent's right to borrow the pledged shares (discussed *infra* at note 75). Treasury has applied options-based constructive ownership principles in other areas. *See*, e.g., T.D. 8853 (January 10, 2000) (citing Rev. Rul. 82-150 as authority for treating a forward purchaser prepaying a forward contract as the owner of certain stock); proposed Treasury regulation section 1.761-3 (listing a number of factors, including reasonable certainty of exercise, considered relevant to the treatment of the holder of an option as a partner in a partnership).

[71]Shapiro reaches the same conclusion after a close parsing of the revenue ruling. *See* Shapiro, *supra* note 53 at 1270 (noting that an out-of-the-money call does not transfer tax ownership when it goes deep-in-the-money and further noting the administrative burden that would be created if the forward seller had to test for an unexpected economic compulsion through the term of the contract). *Cf.* Rev. Rul. 2003-97 ("On the issue date, it is substantially certain that the remarketing will succeed; thus, the consequences of a hypothetical remarketing failure are not controlling.").

[72]*See also* "Guidance on Stock-for-Cash Pledge . . . ," *supra* note 53 at G-1 (reporting that a Treasury official and an IRS official agreed that economic compulsion would be determined on the execution date).

In TAM 200341005 the analysis of each of these factors was made in reference to the execution date and the IRS did not evaluate later events (other than the next day stock offering) to conclude that these factors were not present.[73] If testing is performed as of the execution date, then it would appear that the development of a legal restraint or an economic compulsion (if unexpected) to deliver shares during the term of the VPFC would not affect the common law analysis, although other events could result in a later sale.[74]

**3. Other issues.** The IRS provides a number of details on the VPFC at issue in Rev. Rul. 2003-7. The revenue ruling states (i) the publicly traded nature of the underlying stock and its current trading price, (ii) the term of the VPFC, (iii) the sharing ratios, (iv) the forward seller's voting rights and right to dividends, and (v) the collateralization of the VPFC. Taxpayers entering into transactions that replicate this VPFC should feel comfortable that they have not caused a common law sale of the shares. Modest variations from the revenue ruling's facts would not appear to adversely affect the conclusions regarding a common law sale.[75] However, altering the economics of the contract could prove hazardous to fitting within Rev. Rul. 2003-7, although not necessarily under the common law.

The economics of a VPFC can be significantly changed by, for example, extending the term, narrowing the "spread" of retained appreciation, or increasing the upfront payment when the forward purchaser is entitled to the value of the projected dividends over the term of the contract. In large part, these potential variations relate to the opportunity for gain and risk of loss. Under the common law analysis in Rev. Rul. 2003-7, the IRS focused primarily on the retention of various rights other than the opportunity for gain and the risk of loss in concluding that there was not a sale on the execution date. This analysis supports the conclusion that this factor may be relevant to the common law tax ownership of securities, but it is not critical if the other significant rights are retained.[76] As discussed below, section 1259 focuses exclusively on the taxpayer's opportunity for gain and risk of loss (including, in some cases, the right to dividends) without regard to the other factors relevant to common law sales.[77]

## B. VPFCs and Section 1259 Constructive Sales

Rev. Rul. 2003-7 is the only authoritative pronouncement interpreting whether execution of a VPFC may result in a constructive sale under section 1259. Unlike the common law test for the tax ownership of publicly traded securities, section 1259 is focused solely on the right to appreciation (including, in some cases, the right to dividends) and risk of depreciation. Rev. Rul. 2003-7 addresses only one question under section 1259 — whether a particular VPFC is a section 1259(d)(1) forward contract that causes a constructive sale under section 1259(c)(1)(C). This question is answered in the negative without elaboration, leaving open at least two additional questions: (i) when a particular VPFC would be a section 1259(d)(1) forward contract and (ii) whether a VPFC, even if excepted from section 1259(c)(1)(C), might be recharacterized into a different financial transaction that results in a constructive sale

[73]TAM 200341005 is discussed in James H. Combs and Alexander G. Domenicucci, "IRS Treats Obligation to Deliver Securities (and/or Cash) Under Variable Prepaid Forward Contract as Partnership Liability — But Proceed with Caution!" *Michigan Tax Lawyer* (Fall 2003). *See also* "Variable Prepaid Forward Arrangement Reduces Ownership for Pooled Accounting," 17 *Journal of Taxation of Financial Institutions* 57 (January/February 2004).

[74]Shapiro, *supra* note 53 at 1268-1269, queries the effect of rights existing as of the execution date subsequently being lost and possibly reacquired, citing the example of a securities loan of the pledged shares from the forward seller to an affiliate of the forward purchaser that is acting as collateral agent. The securities loan may restrict the forward seller's ability to substitute collateral while the shares are on loan, which arguably creates a restriction on the ability to settle the VPFC with the pledged shares. Shapiro concludes that merely granting the right to borrow the pledged shares should not result in a constructive sale, although the loan of the pledged shares could, depending on the facts and circumstances, result in a disposition that is not protected under section 1058. *See* Shapiro, *supra* note 53 at 1269. Other commentators have also discussed the applicability of section 1058 in hedging and monetization transactions where the counterparty (or an affiliate) borrows shares. *See also* Kleinbard, *supra* note 55 at 795; Steinberg, *supra* note 14 at 256-257; Rosenthal and Dyor, *supra* note 17 (text accompanying footnote 24); and Schizer, *supra* note 26 at 1355-1356 (describing use of a separate stock loan agreement and separate collar or VPFC as asserted means to comply with section 1058).

[75]At an ABA Tax Section meeting in May 2003, a panel noted that a formula could be created (e.g., based on earnings) for calculating the amount of stock in a nonpublic company deliverable at settlement. Tapes of this meeting are available through the ABA at http://www.abanet.org. As noted above, the use of an unrelated third-party trust as collateral agent should not be required.

[76]With regard to the right to the upside and risk of the downside, it should be noted that the short-against-the-box authorities, *supra* note 4, support the proposition that under the common law a taxpayer can shift all or substantially all of this right and risk to another person without causing a common law sale of the securities. Congress effectively ratified this conclusion by enacting section 1259.

[77]Prepaid forward contract issues also arise in other contexts. *See* Blake D. Rubin and Andrea M. Whiteway, "New Partnership Liability Regulations Target Abuse but Sweep More Broadly," 100 *Journal of Taxation* 2 (February 2004) (discussing VPFCs in the context of proposed regulations defining liabilities for purposes of section 752); Bruce Lemons, James Whitmire, and Randy Bickham, "The New Definition of 'Liability' and its Effect on Prepaid Forward Contracts," *Tax Notes*, Sept. 8, 2003, p. 1307. Treasury has enacted rules countering charitable remainder trust techniques for extracting the value of built-in appreciation of property without income or gain to the annuitant using prepaid forwards. *See* Treasury regulation section 1.643(a)-8(b)(3); T.D. 8926 (January 5, 2001).

under another provision of section 1259(c).[78] How Treasury and the IRS ultimately answer these questions will affect the consistent taxation of economically equivalent financial transactions.

**1. 'Substantially fixed' versus 'significant variation.'** A forward sale of an appreciated financial position results in a constructive sale under section 1259(c)(1)(C) (unless the exception in section 1259(c)(2) applies). For purposes of this rule, Congress did not rely exclusively on the common law or other sources for the definition of a "forward contract."[79] Instead, section 1259(d)(1) provides a statutory definition: A contract is a forward contract for purposes of section 1259 only if there is future delivery of a "substantially fixed" amount of property for a "substantially fixed" price.[80] The legislative history offers little insight into when an amount or price is "substantially fixed," stating only that a contract with a "significant variation" in the amount of property to be delivered is not a forward contract. Without any additional guidance as to the meaning of "significant variation" in this context, taxpayers' only other interpretative aid is legislative history indicating that entering into a forward contract is the type of financial transaction that eliminates "substantially all" of the opportunity for gain and risk of loss. However, "substantially all" similarly is not defined in the statute or legislative history and taxpayers are left only with the other enumerated constructive sale transactions as examples of when the "substantially all" standard is met.[81]

Rev. Rul. 2003-7 concludes that a variation from 80 to 100 shares deliverable at settlement is "significant." (Presumably, it is the 20 percent variation in the number of shares rather than the difference of 20 shares that controls this conclusion.) Therefore, the contract is not a "forward contract" requiring delivery of a "substantially fixed" amount of property. The IRS does not provide any analysis for why this variation is "significant," nor is any indication given that the 20 percent variation is a conservative or aggressive position.[82] Given the lack of any analysis or any cite to authority as a reference for this conclusion, it appears that taxpayers still must determine whether a variation in the amount of shares that is less than 20 percent eliminates "substantially all" of the risk of loss and opportunity for gain.

The standard for section 1259(d)(1) does not take into account the amount of the prepayment, whether

[78]Some commentators have suggested that statutory construction conventions would preclude a constructive sale under section 1259(c)(1)(E) if the contract did not cause a constructive sale under one of the core provisions. *See* Lee A. Sheppard, "Borrowing All the Way to a Constructive Sale," *Tax Notes*, Aug. 9, 1999, p. 816 (stating that "[v]ariable delivery forward contracts with significant variations would fall under the residual clause of proposed section 1259(c)(1)(E)," but noting that the exception for DECS from section 1259(c)(1)(C) would appear to prevent a challenge under section 1259(c)(1)(E)); Rubinger, *supra* note 30 at 6 ("Accordingly, because a specific definition of forward contract exists under section 1259, and given that DECS fails to satisfy this definition, the IRS should be prevented from characterizing DECS as something other than a forward contract under that section as a matter of statutory construction (i.e., the more specific controls the general). Whether the IRS agrees with this position remains to be seen.").

[79]In the subsequently enacted constructive ownership rules, section 1260(d)(4) defines a "forward contract" as "any contract to acquire in the future (or provide or receive credit for the future value of) any financial asset."

[80]It has been reported that the issuers of DECS-type instruments lobbied for the exclusion of these transactions from section 1259, which resulted in the requirement of a "substantially fixed" amount of property for forward contracts. *See* Lee A. Sheppard, "Rethinking DECS, and New Ways to Carve Out Debt," *Tax Notes*, Apr. 19, 1999, p. 347; letter dated February 14, 1997, from Deryck C. Maughan to the Deputy Secretary of the Treasury Department, Lawrence Summers, *Doc 97-5542 (4 pages), 97 TNT 39-40* (stating the writer's belief that DECS were not affected by the short-against-the-box proposal in President Clinton's 1998 budget).

[81]In other contexts, "substantially all" has been interpreted to mean 90 percent of net assets and 70 percent of gross assets. Rev. Proc. 77-37, 1977-2 C.B. 568. *See also* Rudnick and Petock, *supra* note 10 at 61 (footnote 57 and cites therein); letter dated January 22, 1998 from William P. McClure and Geoffrey B. Lanning to Donald C. Lubick, assistant secretary for tax policy, *Doc 98-8056 (10 pages), 98 TNT 43-23* (suggesting a 90 percent measure for "substantially all" and citing Rev. Proc. 77-37, Treasury regulation section 1.448-1T(e)(4) ("substantially all" equals 95 percent), and Treasury regulation section 1.731-2(c)(3)(i) ("substantially all" equals 90 percent); Harmon and Breen, *supra* note 34 at 9 (footnote 32 and cites therein); and "Coalition Addresses Constructive Sales in Options Transactions," *Doc 98-31250 (68 pages), 98 TNT 205-30* (letter from William M. Paul on behalf of the Ad Hoc Coalition of Intermarket Coordination advocating 90 percent standard for substantially all). "Substantially all" has also been interpreted in the section 513 unrelated trade or business context. *Compare St. Joseph Farms v. Comm'r*, 85 T.C. 9 (1985), *nonacq.* 1986-2 C.B. 1 (94 percent meets the substantially all test) and *Waco Lodge No. 166 Benevolent and Protective Order of Elks v. Comm'r*, 696 F.2d 372 (5th Cir. 1983) (76.9 percent does not meet the substantially all test).

[82]Commentators had previously concluded that typical VPFCs are not forward contracts for purposes of section 1259(c)(1)(C). A typical VPFC might provide the forward seller 100 percent of the first 20 percent of appreciation and 16.66 percent of any additional appreciation. Thus, the forward seller would deliver between, *e.g.*, 100 and 83.33 shares, an amount that varies by nearly 17 percent. The 20 percent variation in the revenue ruling exceeds the approximately 17 percent variation in typical VPFCs, but offers no basis for determining whether the IRS would also consider a 17 percent variation "significant." *Cf.* Carlisle, *supra* note 30 at 15; Trier and Farr, *supra* note 44 at 10; and Kleinbard and Nijenhuis, *supra* note 24 at 12 (stating that a "DECS clearly does not constitute a contract to deliver a 'substantially fixed' amount of property"). All DECS-type transactions are not identical, so the variability in each deal must be reviewed. *See* Lee A. Sheppard, "How Kinky? IRS Official Discusses DECS," *Tax Notes*, Dec. 2, 2002, p. 1130. As an example, a VPFC might eliminate all of a forward seller's risk of loss and provide the forward seller 100 percent of the first 40 percent of appreciation.

adjustments for dividends are made, the term of the contract, or the volatility of the underlying stock, all of which would be irrelevant to whether the amount of the property (or price, except perhaps for dividend equivalent payments) was "substantially fixed."[83] The amount of the prepayment in part reflects the pricing of the expected dividends and the right to the dividends would appear relevant to whether the taxpayer relinquished "substantially all" of the opportunity for gain.[84] Similarly, the term of the contract and volatility are also potentially relevant to the portion of the economic attributes retained by the taxpayer. Thus, as explained below, a contract satisfying the "significant variation" test of section 1259(d)(1) could nevertheless have other features that affect whether that contract results in a constructive sale under another provision of section 1259(c)(1).

**2. VPFCs analyzed as other financial transactions.** It appears that the IRS restricted the section 1259 analysis in Rev. Rul. 2003-7 to the significance of the variability in the number of shares potentially deliverable at settlement because the forward sale form of the transaction was respected. As a forward sale, the issue was whether the contract was a forward contract as defined in section 1259(d)(1) and the IRS concluded it was not. This conclusion does not necessarily end the inquiry into whether such a contract can cause a constructive sale because it is possible to recharacterize a VPFC as another type of financial transaction that is or will be covered by section 1259.[85]

**a. Economic equivalency of derivative financial products.** The literature on financial derivatives demonstrates the ability to structure one financial transaction as a combination of transactions or a combination of transactions as a single transaction.[86] Because there is not a systematic approach to the taxation of derivative financial contracts, the after-tax consequences of documenting a transaction as an integrated transaction or multiple transactions can vary.[87] Congress was aware of these structuring opportunities and provided Treasury authority under section 1259(c)(1)(E) to address these transactions the form of which are not described in section 1259(c)(1)(A)-(D), but the economic effects of which are substantially the same. In the legislative history, Congress also empowered Treasury to "aggregate" or "disaggregate" financial transactions to determine whether a constructive sale has occurred.[88] However, Treasury's authority to exercise this power is not absolute: The Conference Report clarifies that "this authority is intended to be used only where such disaggregated treatment reflects the economic reality of the transaction and is administratively feasible."[89]

A transaction documented as a VPFC is potentially susceptible to multiple recharacterizations.[90] Among the alternatives that have been proposed are (i) a notional principal contract, (ii) a collar, or (iii) some other type of financial instrument.[91] The revenue ruling is silent on whether (or when) a VPFC might be analyzed as an offsetting notional principal contract under section 1259(c)(1)(B) or as a collar or some other type of financial transaction that has "substantially the same effect" under section 1259(c)(1)(E) as the four core constructive sale transactions.[92] Rev. Rul. 2003-7 does not

[83]Query whether the price of the stock would be "substantially fixed" if the amount of the dividends on the underlying stock changed over the term of the contract and the forward seller was required to make substantial dividend equivalent payments.

[84]*Cf.* section 1259(c)(1)(B) (offsetting notional principal contract takes into account "investment yield (including appreciation)").

[85]Trier and Farr, *supra* note 44, provide a number of examples of transactions that may be analyzed under the residual clause of section 1259(c)(1)(E), including VPFCs.

[86]*See, e.g.*, Randall K.C. Kau, "Carving Up Assets and Liabilities — Integration or Bifurcation of Financial Products," 68 *Taxes* 1003 (December 1990); Kennard, *supra* note 11 at 21. The ability to replicate transactions using different combinations of financial instruments derives from the put-call parity theorem, which posits that a position in stock can be replicated with a zero-coupon bond, a long call on the stock, and a short put on the stock. *See* Michael S. Knoll, "Put-Call Parity Theorem and the Law," 24 *Cardozo Law Review* 61 (November 2002); and Alvin C. Warren, "Financial Contract Innovation and Income Tax Policy," 107 *Harvard Law Review* 460 (December 1993).

[87]*See* Schizer, *supra* note 30 at 10; Freeman, Stevens, and Hollander, *supra* note 29 at 253 *et seq.*

[88]House Report, *supra* note 41 at 440-441; Senate Report, *supra* note 36 at 124.

[89]An example provided that disaggregation might be warranted if the taxpayer owned appreciated stock and entered into an equity swap referencing a small number of stocks, including the stock that the taxpayer owned. Conference Report, *supra* note 40 at 209.

[90]*See* Levy, *supra* note 8 (analyzing the economic equivalence of prepaid forwards, substantially deep-in-the-money call options, prepaid swaps, contingent debt instruments, and synthetic prepaid forwards); Kleinbard and Nijenhuis, *supra* note 24 at 29 *et seq.* The revenue ruling does not treat the VPFC as a contingent payment (or other) debt instrument. *See* Prusiecki, *supra* note 53.

[91]*See* FSA 199940007 as supplemented by FSA 200130010 (stating that the "cash settlement collar" described in FSA 199940007 could also be analyzed as a prepaid forward, notional principal contract similar to an equity swap, or *sui generis*); FSA 200131015 (employing similar analysis regarding similar instruments); FSA 200150012 (same). *Cf.* Schizer, *supra* note 30 at 10 (DECS may be documented as a contingent payment debt instrument, prepaid forward, or fixed-rate debt coupled with a nonprepaid forward). Although a short sale involves an agreement to sell stock on a forward basis, VPFCs do not involve a borrowing of shares and, therefore, appear to be outside of section 1259(c)(1)(A). For a rejection of the argument that a forward sale is a short sale, see Edward D. Kleinbard and Erika W. Nijenhuis, "Short Sales and Short Sale Principles in Contemporary Applications," 53 *New York University Institute on Federal Taxation* part 1, ch. 17 (1995) at 17-40 through 17-44.

[92]A recharacterization as a nonprepaid forward contract and a zero-coupon loan would present the same analytical issues under section 1259 as a prepaid forward. Rev. Rul. 2003-7 respects the documentation as a unitary contract for the forward sale of shares.

appear to foreclose the argument by the IRS that the VPFC causes a constructive sale under one of these other provisions. However, the economic equivalency of different derivative financial products (or combinations of derivative financial products) that permits the recharacterization of a financial transaction also generally appears to support a consistent result under the section 1259 constructive sale rules (that is, if a transaction does not cause a constructive sale under one provision of section 1259(c)(1), then in general it should not cause a constructive sale under another provision of section 1259(c)(1)). As discussed below, this conclusion may not always hold true.

**b. Section 1259(c)(1)(B).** Section 1259(c)(1)(B) provides that entry into an "offsetting notional principal contract" regarding property that is the same or substantially identical to an appreciated financial position held by the taxpayer results in a constructive sale. Section 1259(d)(2) defines an "offsetting notional principal contract" as "an agreement which includes — (A) a requirement to pay (or provide credit for) all or substantially all of the investment yield (including appreciation) on such property for a specified period, and (B) a right to be reimbursed for (or receive credit for) all or substantially all of any decline in the value of such property."

In FSA 200130010, the IRS revisited an earlier field service advice (FSA 199940007) in which the IRS had stated that a "cash settlement collar" could also be characterized as a prepaid forward. The transaction at issue in the FSAs appeared to resemble a VPFC or DECS-type instrument. FSA 200130010 clarified that another characterization of the transaction was as a type of notional principal contract, an equity swap.[93] The IRS relied on the definition provided in Treasury regulation section 1.446-3(c), which states that "[a] notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts." In a typical equity swap, a taxpayer holding a position in stock would enter into an agreement with a counterparty under which the taxpayer would agree to pay to the counterparty an amount equal to the dividends and other distributions and any appreciation on a notional amount of the stock. In return, the counterparty would agree to pay the taxpayer an amount equal to any depreciation on the notional amount of the stock and, for example, a periodic return such as LIBOR on a notional dollar amount. A notional principal contract can also be prepaid and the IRS has issued regulations regarding the timing of the recognition of income on such contracts.[94]

Based on the definition in the section 446 regulations, it is unlikely that a VPFC is properly characterized as a notional principal contract because the settlement of a VPFC with stock (versus cash) would not be based on a notional amount.[95] Assuming recharacterization of a VPFC as a notional principal contract, a constructive sale under section 1259(c)(1)(B) could occur for an appreciated financial position only if the contract was an "offsetting notional principal contract." To cause a constructive sale, the VPFC would have to require the taxpayer to pay over or credit "substantially all" of the investment yield, including appreciation. Under the terms of the contract in Rev. Rul. 2003-7, the taxpayer eliminated all risk of loss, retained the right to dividends over the term of the contract, retained the right to 100 percent of the first 25 percent of appreciation, and retained the right to 20 percent of any additional appreciation.[96] Such a contract did not cause a constructive sale under section 1259(c)(1)(C) and, it would appear, likewise should not cause a constructive sale under section 1259(c)(1)(B).[97] However, as explored more fully in the discussion of the regulations to be promulgated under section 1259(c)(1)(E) below, in some cases a contract that does not cause a constructive sale under one provision of section 1259(c)(1) could nevertheless result in a constructive sale under another provision.

**c. Section 1259(c)(1)(E).** The residual clause of section 1259(c)(1)(E), to the extent provided in regulations, will include as constructive sales transactions that Treasury determines have "substantially the same effect" as those listed in section 1259(c)(1)(A)-(D) (that is, the transactions that eliminate substantially all of the opportunity for gain and risk of loss).[98] The in-

[93]A notional principal contract can be analogized to a series of forward contracts. *See* Steinberg, *supra* note 14 at 219 (footnote 33); Kleinbard and Nijenhuis, *supra* note 91 at 17-41 (noting "virtually indistinguishable" economics between equity swaps and a series of cash-settled forwards); NYSBA, "Report on Notional Principal Contract Character and Timing Issues," *supra* note 18 (text accompanying footnote 18).

[94]*See* Treasury regulation section 1.446-3(f) (addressing nonperiodic payments in a notional principal contract transaction). Periodic notional principal contract payments are governed by Treasury regulation section 1.446-3(e). *See also* 69 *Federal Register* 8886-8898, Feb. 26, 2004 (proposed regulations on contingent non-periodic payments on a notional principal contract).

[95]*See* Rubinger, *supra* note 51 at 6; Kleinbard and Nijenhuis, *supra* note 24 at 9 (footnote 26).

[96]An economically equivalent equity swap could provide, e.g., that the taxpayer pay a swap counterparty 80 percent of any increase in the value of a notional amount of 100 shares above the first 25 percent of appreciation and the swap counterparty would pay the taxpayer 100 percent of any decrease in the value of a notional amount of 100 shares.

[97]*See* Douglas, *supra* note 53 at 42 (concluding that taxpayers structuring swaps and other financial transactions may be able to avoid section 1259 by retaining an economic interest equivalent to the first 25 percent of appreciation on the underlying position). *Cf.* Rubinger, *supra* note 51 at 6; Freeman, Stevens, and Hollender, *supra* note 29 at 291-292.

[98]It is not clear whether there is a lesser standard under section 1259(c)(1)(E) for constructive sales. That is, the legislative history states that the transactions in section 1259(c)(1)(A)-(D) eliminate "substantially all" of the oppor-

**(Footnote 98 continued on next page.)**

clusion of section 1259(c)(1)(E) and the legislative history thereunder demonstrate Congress's awareness that taxpayers could replicate the economic effect of the four core constructive sale transactions by adopting a different form. Congress anticipated that Treasury would use its authority to promulgate regulations implementing section 1259(c)(1)(E) to "provide specific standards for determining whether several common transactions," including collars, would cause constructive sales. This legislative grant of authority is relevant to VPFCs because it is well-understood that economically a VPFC can be analyzed as a loan to the taxpayer with a collar made up of a put option and a call option.[99]

**i. Collar transactions.** The four enumerated constructive sale transactions require the elimination of substantially all of both the opportunity for gain and the risk of loss.[100] Section 1259(c)(1)(E) was included as a backstop against taxpayers avoiding constructive sale treatment by altering the form of these transactions. A collar is one example of this type of transaction that Congress intended to be addressed in the regulations implementing section 1259(c)(1)(E). The legislative history explains how a collar works with an example:

> In a collar, a taxpayer commits to an option requiring him to sell a financial position at a fixed price (the "call strike price") and has the right to have his position purchased at a lower fixed price (the "put strike price"). For example, a shareholder may enter into a collar for a stock currently trading at $100 with a put strike price of $95 and a call strike price of $110. The effect of the transaction is that the seller has transferred the rights to all gain above the $110 call strike price and all loss below the $95 put strike price; the seller has retained all risk of loss and opportunity for gain in the price range between $95 and $110.[101]

Congress specified that Treasury should consider the following factors in promulgating regulations on collars: (i) volatility of the underlying stock; (ii) the put and call price spread; (iii) the term of the contract; and (iv) the taxpayer's right to periodic payments, such as dividends, on the underlying stock.[102] The volatility factor pertains to the characteristics of the underlying stock, while the right to dividends, spread, and term relate to the collar contract itself. Each factor is important to the determination of how much of the oppor-

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tunity for gain and risk of loss. If a transaction under section 1259(c)(1)(E) only is required to have "substantially the same effect" as one of these transactions, then such a transaction arguably does not have to eliminate "substantially all" of the opportunity for gain and risk of loss, but only a substantial part of substantially all of the opportunity for gain and risk of loss. Mathematically, if 90 percent is substantial, then the issue under section 1259(c)(1)(E) is whether "substantially the same effect" as "substantially all" (i.e., 90 percent) equals 90 percent of 90 percent, or 81 percent. For suggestions on how to apply section 1259(c)(1)(E), see ABA Section of Taxation Committee on Financial Transactions, "Recommendations for the Forthcoming Constructive Sales Regulations," *Tax Notes*, Sept. 24, 2001, p. 1719 at 1722 (ABA Regulations Report) (recommending that Treasury draft section 1259(c)(1)(E) regulations for (i) "costless" collars, *i.e.*, collars in which the taxpayer's net out-of-pocket cost from writing a call and purchasing a put is zero, and out-of-the-money options and (ii) "other transactions, including in-the-money options, collars that are not costless, customized hedging transactions and new financial products").

[99]*See* ABA Regulations Report, *supra* note 98 at 1723 (distinguishing between a "Type I" collar made up of matched puts and calls and a "Type II" collar equivalent to a less than 1:1 ratio of puts and calls). *See also* FSA 200130010; NYSBA, "Comments on H.R. 846," *supra* note 25 (text accompanying footnote 47) (describing a VPFC as having "collar economics"). *Cf.* Boczar, *supra* note 34 at 56 (noting that some market participants describe DECS as "publicly offered collars"); Trier and Farr, *supra* note 44 at 27 (disaggregating a VPFC into a nonvariable forward sale and a combination of call options on subsets of the shares). One reason for adopting a VPFC structure rather than a collar structure is the margin requirement imposed by Federal Reserve rules, which may limit the amount of the borrowing against a collar position to 50 percent of the value of the collared stock; a VPFC may permit the taxpayer to obtain a greater amount of cash against the stock position. *See* Boczar, *supra* note 34 at 50, 56. For a comparison of the potential tax treatment of each transaction, see Prusiecki, *supra* note 53; Rosenthal and Dyor, *supra* note 17.

[100]Entering into a transaction that only eliminates substantially all of the upside opportunity or downside risk does not cause a constructive sale. The legislative history confirms that buying a put on a stock with a strike price equal to the current trading price does not cause a constructive sale be-

**(Footnote 100 continued in next column.)**

cause it eliminates only the risk of loss regarding the stock, but not the opportunity for gain. House Report, *supra* note 41 at 442; Senate Report, *supra* note 36 at 126. This was also the rule under the common law. *Cf.* Rev. Rul. 82-144, 1982-2 C.B. 34 (purchase of put on tax-exempt obligation does not shift tax ownership). The legislative history discusses the use of in-the-money options separately. There is an example of a put option with an exercise price of $120 on stock currently trading at $100. The legislative history did not conclude that this particular option would result in a constructive sale, but stated that "in determining whether such a transaction will be treated as a constructive sale, it is anticipated that Treasury regulations will provide a specific standard that takes into account many of the factors described above regarding collars, including the yield and volatility of the stock and the period and other terms of the option." House Report, *supra* note 41 at 443; Senate Report, *supra* note 36 at 127; *Blue Book*, *supra* note 41 at 178. *Cf.* Rev. Rul. 82-150; Rev. Rul. 85-87. The legislative history states that "if a transaction has the effect of eliminating a *portion* of the taxpayer's risk of loss and a *portion* of the taxpayer's opportunity for gain with respect to an appreciated financial position which, taken together, are substantially all of the taxpayer's risk of loss and opportunity for gain, it is intended that Treasury regulations will treat this transaction as a constructive sale of the position." Senate Report, *supra* note 36 at 126 (emphasis in original).

[101]House Report, *supra* note 41 at 443; Senate Report, *supra* note 36 at 126. In further acknowledgement that financial transactions can be formatted in various ways, the legislative history notes that "[a] collar can be a single contract or can be affected by using a combination of put and call options." Senate Report, *supra* note 36 at 126-127.

[102]House Report, *supra* note 41 at 443; Senate Report, *supra* note 36 at 127.

tunity for gain and risk of loss the collar has eliminated for the collar participant. The spread is important because it establishes the range of values over which the taxpayer has economic exposure to the stock. However, the spread alone is generally an imprecise gauge of the extent of the taxpayer's hedge because volatility and term impact the effectiveness of the hedge. The more volatile the price of a stock, the more likely the price will trade outside a given spread. The longer the term of the contract, all other things equal, the more likely it is that the stock will trade outside a given spread. The right to periodic payments such as dividends is also important because dividends entitle the taxpayer to receive distributions of the earnings of a company.[103] Congress expected that the regulations applying the foregoing factors to collars would "be applied prospectively, except in cases to prevent abuse."[104]

Congress directed Treasury to establish safe harbors for "common financial transactions" not causing constructive sales of appreciated financial positions, including, for example, "a collar with a sufficient spread between the put and call prices, a sufficiently limited period and other relevant terms such that, regardless of the particular characteristics of the stock, the collar probably would not transfer substantially all risk of loss and opportunity for gain."[105] However, Congress did not indicate when a collar would have a "sufficient spread," a "sufficiently limited period," or other relevant terms to qualify for such a safe harbor. The example in the legislative history had a spread of 15 percent (that is, from $95 to $110, which equals 15 percent of the $100 stock price on the execution date), but omitted information on the term, right to dividends, or volatility of the stock. Congress did not indicate whether the 15 percent spread was sufficient either to avoid a constructive sale in general or satisfy a spread-based safe harbor, and the example may merely have been intended to illustrate a collar transaction.[106]

Congress also suggested that Treasury consider use of an alternative method to evaluate collars.

> For collars, options, and some other transactions, one approach that Treasury might take in issuing regulations is to rely on option prices and option pricing models. The price of an option represents the payment the market requires to eliminate risk of loss (for a put option) and to purchase the right to receive yield and gain (for a call option). Thus, 'option pricing offers one model for quantifying both the total risk of loss and opportunity for gain with respect to an appreciated financial position, as well as the proportions of these total amounts that the taxpayer has retained.[107]

An options-pricing model analyzes the cost of the options that enable a taxpayer to alter his exposure to price fluctuations of a stock. For example, a taxpayer that holds appreciated stock trading at $100 per share can acquire an at-the-money put (strike price equals $100) for $21 and can write a call with a strike price of $115 for $25. The cost of a call with a strike price of $100 is $35. The taxpayer thus can eliminate 100 percent of the risk for the term of the option if the at-the-money put is acquired; the cost of retaining a portion of the upside from $100 to $115 is $10 (which equals the difference between the cost of the call exercisable at $100 and

[103]It is possible to structure a collar otherwise identical to the VPFC in Rev. Rul. 2003-7 that entitles the counterparty to the economic benefit of the dividends. This may be accomplished, presumably without jeopardizing the common-law treatment of the transaction, by having the collar holder make dividend equivalent payments to the counterparty. Steinberg, *supra* note 14 at 216 (footnote 19), notes that the option prices in a collar may be adjusted by the value of the projected amount of dividends paid on the stock over the term of the agreement, thus building this factor into the spread.

[104]Conference Report, *supra* note 40 at 209. Section 7805(b)(3) provides that the Secretary can retroactively apply or make effective regulations in order to prevent abuse. It has been suggested that a clear case of an abusive collar would be put and call options exercisable at the same strike price. *See* Kramer, *supra* note 3 at 45-43. Such an option collar is economically equivalent to a forward contract if the options are exercisable on the same date. Two common-law authorities that do not involve collars but that do address reciprocal put-call option arrangements for the purchase of stock are *Penn-Dixie Steel Corp. v. Comm'r*, 69 T.C. 837 (1978) (grant of reciprocal put and call options on stock exercisable in consecutive one-year periods at same price does not result in current sale), and *Griffin Paper Corp., et al. v. Comm'r*, T.C. Memo. 1997-409, *Doc 97-26223 (21 pages)*, *97 TNT 180-7* (reciprocal put and call options exercisable on the same date did not result in sale of stock until exercise of option).

[105]House Report, *supra* note 41 at 443-444; Senate Report, *supra* note 36 at 127. The NYSBA has suggested a safe harbor for collar transactions with the following features: (i) a three- or five-year term; (ii) a 20 percent spread based on the collared security's current trading price; and (iii) a spread including the trading price of the security. *See* NYSBA, "Comments on 'Short-Against-the-Box' Proposal," *supra* note 34 (text accompanying footnotes 24-26). The ABA has suggested safe harbors based on the duration of the collar and the "width" of the collar. The ABA recommends (i) a 5.9 percent width for a zero-to-six-month collar, (ii) a 9.0 percent width for a greater-than-six-months, but less-than-one-year collar, (iii) a 14.5 percent width for a greater-than-one-year-but-less-than-two-year collar, (iv) a 20 percent width for a greater-than-two-years-but-less-than-three-year collar, (v) a 26 percent width for a greater-than-three-years-but-less-than-four-year collar, and (vi) a 32.5 percent width for a greater-than-four-years, but less-than-five-years collar. ABA Regulations Report, *supra* note 98 at 1724.

**(Footnote 105 continued in next column.)**

[106]One commentator has recommended, based on this example, that a 15 percent spread does not cause a constructive sale. *See* Mark Fichtenbaum, "Structuring Collars and Making Proper Identifications After Ltr. Rul. 199925044," 17 *Journal of Taxation of Investments* 188 (Spring 2000). *See also* Harmon and Breen, *supra* note 34 at 9 (stating that "investors have become comfortable that a collar is not abusive if it is: (1) a short-term collar (one to two years) with at least a 10 percent spread; (2) a five-year-or-less term collar with a 15 percent spread, and (3) a longer-term collar with a spread of at least 20 percent.").

[107]House Report, *supra* note 41 at 443; Senate Report, *supra* note 36 at 127.

the call exercisable at $115). The quotient of this difference divided by the sum of cost of the call exercisable at $115 and the call exercisable at $100 is 17 percent (($35 – $25)/$60), indicating that the taxpayer has retained this percentage of the upside.[108] As with the suggested spread-based safe harbor, Congress did not establish a minimum percentage of retained opportunity for gain and risk of loss that would avoid the constructive sale rules.[109]

**ii. Collar analysis and implications for consistent treatment of equivalent financial transactions under the section 1259(c)(1)(E) regulations.** Rev. Rul. 2003-7 in form presents a prepaid forward sale of a variable amount of stock and the constructive sale analysis, limited to section 1259(c)(1)(C), respects this form. However, disaggregation of the VPFC into a collar transaction for purposes of constructive sale analysis would not appear to be inappropriate. In the Conference Report, Congress clarified that Treasury should limit the use of its regulatory authority to disaggregate "where such disaggregated treatment reflects the economics of the transaction and is administratively feasible." There seems to be little dispute as to the economics of a VPFC transaction and administrative feasibility would not appear to preclude collar analysis.[110] The VPFC described in Rev. Rul. 2003-7 is economically equivalent to a collar where the taxpayer is short a three-year, European-style, cash-settled call option on 80 shares with a strike price of $25 and is a long three-year, European-style, cash-settled put on 100 shares with a strike price of $20 per share.[111] The collar is on 80 shares because 20 of the shares are subject to an at-the-money put only.[112] The spread is 25 percent of the underlying stock's current trading price.

The recharacterization of the VPFC as a collar transaction presents the opportunity to explore how Treasury and the IRS may address collar transactions in the regulations to be promulgated under section 1259(c)(1)(E), and the role of consistency in the treatment of equivalent financial transactions under section 1259. Treasury has not drafted regulations under section 1259(c)(1)(E) nor does it appear that such regulations are on the horizon.[113] However, the legislative history's extensive discussion of collars does provide a basis for analyzing the VPFC in Rev. Rul. 2003-7. A key question for taxpayers is whether the revenue ruling supports the proposition that an equivalent collar (with a 25 percent spread) will not cause a constructive sale under section 1259(c)(1)(E).

The first step in analyzing whether a collar will cause a constructive sale of an underlying appreciated financial position under section 1259(c)(1)(E) is to determine whether the collar has "substantially the same effect" as the transactions listed in section

[108]This example is included in the Appendix to the NYSBA's "Comments on H.R. 846," *supra* note 25. One shortcoming of an options-pricing model is potential differences of opinion regarding the volatility of the underlying stock, which affects the pricing of the options. For a discussion of an options pricing-based safe harbor, see Schizer, *supra* note 30 at 14-16; NYSBA, "Comments on 'Short-Against-the-Box' Proposal," *supra* note 34 (text accompanying footnote 17). For analysis of an option-pricing model and other analytical approaches, see Trier and Farr, *supra* note 44 at 12-14 (noting that the amount of the prepayment relative to the fair market value of the securities or a "delta" analysis of the derivatives are alternatives). Options may be priced under a formula such as the Black-Scholes model. *See* ABA Regulations Report, *supra* note 98 at 1726.

[109]The NYSBA has proposed 10 percent as a safe harbor, but left open the possibility that a lesser percentage would be sufficient. *See* NYSBA, "Comments on H.R. 846," *supra* note 25 (text accompanying footnotes 39 and 40).

[110]While an analysis based on the spread of the collar may be possible, there may not necessarily be option prices available to analyze the collar under an options-pricing model.

[111]The prepayment can be accounted for on a pretax basis as a loan or deposit. If a collar coupled with a loan transaction were entered into, the interest on the loan would be subject to capitalization under section 263(g) (with a potential offset for, among other items, dividend income from the collared stock) because it is incurred in a section 1092 straddle. *See* Steinberg, *supra* note 14 at 249.

[112]As noted above, the ABA Regulations Report describes this as a "Type II" collar because the put and call components are not equal in number. Regarding the 20 shares that are not collared, the taxpayer has eliminated only the risk of loss (but not the opportunity for gain). House Report, *supra* note 41 at 442; Senate Report, *supra* note 36 at 126. The legislative history further indicates that the taxpayer may constructively sell some, but not all, of the shares that he owns. House Report, *supra* note 41 at 440-441; Senate Report, *supra* note 36 at 124. Trier and Farr, *supra* note 44 at 28, point out that the right to appreciation in a VPFC can be viewed in two ways: (i) the retention of a proportionate amount of the appreciation regarding all of the shares or (ii) the retention of the appreciation regarding only a portion of the shares. On the facts in the revenue ruling, this is the difference between retaining 20 percent of the appreciation above the first 25 percent appreciation on 100 shares or retaining 100 percent of the appreciation above the first 25 percent appreciation on 20 shares. *See also* NYSBA, "Comments on 'Short-Against-the-Box' Proposal," *supra* note 34 (footnote 22); NYSBA, "Comments on H.R. 846," *supra* note 25 (footnote 72); and Schizer, *supra* note 30 at 16 (footnote 51) (describing the NYSBA approach, which ignores the retained appreciation above the call strike price). Treasury officials have unofficially taken the position that all 100 shares would be sold, although the opportunity for gain on 20 shares has not been relinquished. *See* Sheppard, *supra* note 53 at 651.

[113]It has been reported that proposed regulations were near publication in 2000. *See* Lee A. Sheppard, "Can Corporate Issuers Dial Up an Overstated Interest Deduction?" *Tax Notes*, Feb. 7, 2000, p. 587 at 590. The IRS has eliminated section 1259 from its guidance plan for 2003-2004. According to one report, an official from the IRS stated that the relatively clear legislative history on collars (which the author of the article described as "permissive") was a reason for not keeping section 1259 on the guidance plan. *See* Lee A. Sheppard, "ABA Meeting Ponders Tax Shelters and Financial Transactions," *Tax Notes*, Sept. 22, 2003, p. 1490. Tapes of the Fall 2003 ABA Section of Taxation Financial Transactions Committee meeting indicate the view of some in the government that the market has evolved to a point that advice on constructive sales has been reasonably conservative.

1259(c)(1)(A)-(D). To make this determination, it is necessary to define the "effect" of the four core constructive sale provisions. The statute's only guidance on this point is a description of the transactions, including a forward sale, that cause constructive sales.[114] The legislative history indicates that these transactions transfer "substantially all" of the opportunity for gain and risk of loss to another party, but provides no additional standard for when a transaction does or does not cause a constructive sale.[115]

In Rev. Rul. 2003-7, the IRS ruled that a VPFC with a 20 percent variation did not cause a constructive sale under section 1259(c)(1)(C). Facially, it might appear that the fact that the VPFC did not cause a constructive sale under section 1259(c)(1)(C) should lead to the conclusion that the same transaction, recharacterized as a collar, should not result in a constructive sale under section 1259(c)(1)(E). If economically equivalent transactions were treated differently under one provision versus another, then the IRS and taxpayers would attempt to classify the transaction to fit within the provision more favorable to its position on the constructive sale issue. This would lead to disputes over whether a particular (re)characterization was proper and whether the form of the contract should be respected. The consistent treatment of economically equivalent transactions would avoid these disputes. However, consistent treatment does not mean that the avoidance of a constructive sale under section 1259(c)(1)(A)-(D) inevitably results in avoidance of a constructive sale under section 1259(c)(1)(E).

For there to be consistent treatment of economically equivalent transactions across the provisions of section 1259, it is necessary to determine whether a transaction that avoids a constructive sale under section 1259(c)(1)(A)-(D) does not cause a constructive sale in any event. In certain cases, a transaction that is not, for example, a forward contract that causes a section 1259(c)(1)(C) constructive sale, would not warrant consistent treatment if analyzed as a collar under section 1259(c)(1)(E). An example of this would be a VPFC identical to the one described in Rev. Rul. 2003-7 but which required the forward seller to make dividend equivalent payments (the facts of Rev. Rul. 2003-7 do not suggest that the forward seller made dividend equivalent payments).[116] These payments would not affect the section 1259(c)(1)(C) analysis (such payments being irrelevant to the "significant variation" standard), but would transfer a portion of the right to future appreciation to the forward purchaser.[117] If the payments were sufficiently large, the forward seller might be determined to have relinquished "substantially all" of the right to appreciation regarding the underlying appreciated financial position and, thus, there could be a constructive sale because all of the risk of loss was also shifted. This scenario demonstrates that avoiding a constructive sale under section 1259(c)(1)(C) does not unequivocally mean that a transaction does not cause a constructive sale in general.[118]

Rev. Rul. 2003-7 concludes only that the VPFC does not cause a constructive sale under section 1259(c)(1)(C). This leaves open the possibility that the VPFC described in Rev. Rul. 2003-7 could result in a constructive sale under section 1259(c)(1)(E) because, for example, the term of the contract relative to the spread was not sufficiently short or due to the volatility of the underlying stock. If the VPFC described in Rev. Rul. 2003-7 did result in a constructive sale, then at a minimum it would appear to be an example of a collar

[114]In the ABA Regulations Report, the authors described a transaction that did not have substantially the same effect as one in which the "taxpayer has retained meaningful economic attributes of ownership of the underlying property . . . ." The retention of 5 percent to 10 percent of the economic attributes was considered "significant or meaningful." *See* ABA Regulations Report, *supra* note 98 at 1722. The report later notes that short sales, offsetting notional principal contracts and forward contracts "function as a complete hedge of all or part of the appreciated financial position when entered into (that is, they have a negative correlation) and, equally as important, all three of these transactions are reasonably expected to maintain their effectiveness as hedges as the value of the appreciated financial position changes (that is, they do not need to be constantly adjusted)." ABA Regulations Report, *supra* note 98 at 1729 (recommending as one approach that "inverse correlation" and "constant effectiveness" as the basis for the "substantially the same effect" test).

[115]Interestingly, having to focus on the "substantially all" standard as the relevant touchstone hearkens back to the initial constructive sale proposal, which statutorily imposed a similar standard. *See* Paul, "Constructive Sales Under New Section 1259," *supra* note 34 at 1470.

[116]Given that dividend equivalent payments would not be needed to accomplish a similar economic result because the parties can negotiate the amount of the upfront payment to reflect the allocation of the projected dividends, query how this would affect the constructive sale analysis. Rev. Rul. 2003-7 specified neither the relative size of the dividends nor the amount of the prepayment relative to the trading price of the stock, making it difficult to reach any conclusions on this point. The extent of monetization is not a factor that generally appears to be relevant under section 1259. *See* Rudnick and Petock, *supra* note 10 at 28; Trier and Farr, *supra* note 44 at 5-6 (also noting that credit risk is irrelevant under the constructive sale rules, although such risk can affect the terms of a financial contract).

[117]The term of a contract and volatility are two other factors that are not considered under section 1259(c)(1)(C), but which Congress mentioned as relevant to collar analysis.

[118]A similar point was made by government representatives in unofficial statements that suggested that Rev. Rul. 2003-7 cannot be extended to collar transactions. *See* Sheppard, *supra* note 53 at 651 (noting that IRS officials have disclaimed any implications for safe harbors for collars); Stratton, *supra* note 62 at 1315 (reporting that a co-author of Rev. Rul. 2003-7 stated that her immediate reaction to whether a collar with the same economics as the contract described in the revenue ruling would not cause a constructive sale "would be no because the ruling relied on a limited definition of forward contract under section 1259."). Prusiecki, *supra* note 53 at 775, suggests that Rev. Rul. 2003-7 can be read as support for wrapping "loan, collar, option, monetization, and other elements into different, larger transactions."

that is not abusive.[119] Whether a transaction is "abusive" is a relevant concern for taxpayers entering into collars, at least until the promulgation of regulations under section 1259(c)(1)(E), because nonabusive collars should be grandfathered under the regulations. It appears unlikely that the VPFC transaction in Rev. Rul. 2003-7 is an abusive case because (i) the example in the legislative history of a collar with a 15 percent spread was not identified as abusive (although the term of the contract was not specified) and (ii) a contrary conclusion would result in taxpayers being induced by the revenue ruling into structuring transactions that can be challenged on a retroactive basis.[120] Therefore, it appears that taxpayers entering into a VPFC with identical terms as the one described in Rev. Rul. 2003-7 can conclude that the regulations to be promulgated under section 1259(c)(1)(E) will not provide that a three-year collar that eliminates all risk of loss, has a 25 percent spread, and entitles the collar holder to the dividends, causes a constructive sale that is abusive.

If Rev. Rul. 2003-7 simply establishes what is not an abusive collar, then it follows that the IRS has not indirectly established, in advance of the regulations, a spread-based safe harbor for collar transactions because a transaction that met such a safe harbor would not cause a constructive sale in any event.[121] It is possible to make at least two observations from the conclusion that collars economically equivalent to the VPFC in Rev. Rul. 2003-7 may result in a constructive sale under the regulations. First, the government may ultimately take the position that a spread-based safe harbor may require a spread in excess of 25 percent for a three-year collar eliminating all risk of loss when the taxpayer retains the right to dividends. It should be noted that the spread apparently countenanced by the revenue ruling as nonabusive either exceeds or approximates the spread-based safe harbors advocated by the various tax bar committees that have commented on section 1259.[122] Second, Treasury and the IRS may be reserving for the possibility that an options pricing-based safe harbor will be employed in the alternative to, or in conjunction with, a spread-based safe harbor. If option prices are used to determine whether a taxpayer has retained a sufficient amount of economic attributes to avoid the constructive sale rules, it is possible that such a safe harbor could conflict with the spread-based safe harbor. A spread-based safe harbor is intended to provide certainty to taxpayers without regard to the volatility of the underlying securities. As a result, to be effective the spread must be sufficiently large so that it would generally apply to even volatile securities.[123] A volatile security that satisfies the spread-based safe harbor might not meet an options pricing-based safe harbor because the volatility would affect the pricing of the options. In the event of a conflict between eligibility for the two safe harbors, Treasury and the IRS would have to resolve how the safe harbors would apply.[124]

The foregoing underscores some of the difficult questions that Treasury and the IRS must grapple with in implementing section 1259(c)(1)(E). What is the "effect" of the transactions described in section 1259(c)(1)(A)-(D)? When does a transaction have "substantially the same effect" as those described in section 1259(c)(1)(A)-(D)? When should a transaction that resembles the type of transaction described in section 1259(c)(1)(A)-(D) but does not cause a constructive sale under those provisions be recharacterized as a transaction to be tested under section 1259(c)(1)(E)? If such a transaction is recharacterized, when should there be a constructive sale under section 1259(c)(1)(E) when there is not a constructive sale under section 1259(c)(1)(A)-(D)? What is the role of section 1259(c)(1)(E) in the context of the statute? Should both a spread-based safe harbor and an options pricing-

[119]*See* Shapiro, *supra* note 53 at 1271 ("It would appear that taxpayers can assume that the option collar described in Rev. Rul. 2003-7 does not represent an 'abuse' to which regulations will apply retroactively — if it did, the ruling would have had to so indicate."); "Ruling on Pledge . . . ," *supra* note 53 at G-2.

[120]Before Rev. Rul. 2003-7, an IRS official informally suggested that a collar with a range of 20 percent would not result in a constructive sale. *See* "IRS Looking for 20 Percent Safe Harbor for Collars under Constructive Sale Rules," *DTR* G-2 (July 1, 1998). More recently, Treasury officials have noted that a 20 percent spread might eliminate almost all risk based on the term of the contract and the volatility of the underlying stock. Treasury officials indicated that Treasury did not know how collars would be addressed in the regulations. *See* Lee A. Sheppard, "Financial Products Guidance Update," *Tax Notes*, Dec. 9, 2002, p. 1267.

[121]The VPFC described in the revenue ruling does have three features that Congress anticipated would be relevant to a spread-based safe harbor: the term of the contract (three years), the spread (from $20 to $25), and the forward seller's right to dividends. Although the volatility of the stock is not mentioned in the revenue ruling, the legislative history stated Congress's expectation that Treasury could establish a spread-based safe harbor that would apply without regard to volatility.

[122]The collar would meet the NYSBA's spread-based safe harbor because the spread exceeds 20 percent, the spread includes the current trading price, and the contract has a three-year term. The collar would be consistent with the ABA's recommendations for two-to-three-year collars (20 percent spread) and three-to-four-year collars (26 percent spread).

[123]The ABA Regulations Report, *supra* note 98 at 1725, stated that "Most participants in this report believe a strong argument can be made on statutory and policy grounds alone that volatility should play no role in determining whether a collar has 'substantially the same effect' as an outright sale or forward contract at a fixed price." The authors concluded that an "80-120" collar appeared "sufficiently distinguishable" from a sale (or fully hedged position) irrespective of the underlying stock's volatility.

[124]Some of the authors of the ABA Regulations Report recommended that volatility not be considered in establishing a safe harbor for collars because of concerns about the complexity of pricing the options. If such an approach was adopted, the authors recommended that both a spread-based safe harbor and an option-pricing-based safe harbor be used and that taxpayers qualifying for either of the safe harbors would avoid a constructive sale. *See* ABA Regulations Report, *supra* note 98 at 1725-1728.

based safe harbor be used? If both are used, should one safe harbor prevail over the other? These questions and others will be relevant in the promulgation of regulations and the establishment of safe harbors. Once Treasury and the IRS provide taxpayers with examples of transactions that do not, in any case, cause a constructive sale, then taxpayers will be able to more confidently structure economically equivalent transactions using alternative forms.[125] Rev. Rul. 2003-7 does not fulfill this role because it is limited to whether the VPFC causes a constructive sale under section 1259(c)(1)(C) and does not state that the VPFC could not cause a constructive sale under another provision of section 1259(c)(1). Therefore, one cannot unequivocally conclude that the VPFC described in Rev. Rul. 2003-7 will not cause a constructive sale under the section 1259(c)(1)(E) regulations if analyzed as a collar.

## IV. Conclusion

In 1997 Congress enacted section 1259 in response to perceived abuses by taxpayers using hedging and monetization strategies to achieve the equivalent of an economic sale of appreciated positions in securities without divesting themselves of tax ownership. This provision did not preempt the previously established common law of sales, requiring taxpayers who continue to use hedging and monetization strategies to consider two independent sets of rules. From a common law perspective, Rev. Rul. 2003-7 is an important piece of guidance because it details the factors that IRS field agents will be relying upon in audits of taxpayers who have entered into VPFCs. However, the revenue ruling is a mixed blessing in this respect on account of the introduction of two vaguely defined factors — unrestricted legal rights and economic compulsion. The tax administrators' interpretations of these factors await development.

Perhaps more interesting to practitioners are the implications that Rev. Rul. 2003-7 may have for the interpretation of section 1259(c)(1)(E) in the long-awaited regulations. It is possible to conclude from the revenue ruling that the VPFC described therein is not an example of an abusive collar. However, it appears difficult to draw further conclusions from the revenue ruling before the promulgation of regulations under section 259(c)(1)(E). Because of the economic equivalence of various financial transactions, the IRS and Treasury should focus on publishing regulations under section 1259(c)(1)(E). The regulations should (i) confirm that the VPFC is not an abusive collar, (ii) indicate whether, in Treasury's view, the VPFC does cause a constructive sale that is not abusive, or does not cause a constructive sale but falls outside of a collar safe harbor, and (iii) execute congressional intent that there be a safe harbor for common financial transactions. These answers would permit taxpayers to more confidently enter into hedging transactions without the chill effect on transactions at the margin of the constructive sale rules that is caused by the absence of definite rules. Furthermore, without this guidance it is not possible to determine how the IRS and Treasury view the interaction of the residual clause of section 1259(c)(1)(E) with the four core constructive sale provisions of section 1259(c)(1)(A)-(D). This guidance is needed to promote consistency rather than incongruities between the taxation of economically equivalent VPFCs, collars, and other financial transactions.

[125]Rev. Rul. 2003-7 does not assist taxpayers in assessing whether the variation or spread is conservative. This has significance for planning purposes because, *e.g.*, a safe harbor by implication would be a conservative position and potentially permit more aggressive planning. Of course, to the extent that the policymakers at Treasury and enforcers at the IRS do not want greater certainty because hedging and monetization transactions may reduce current tax revenues (as opposed to a taxable sale), the government may not have an incentive to publish more precise guidance in this area. Government officials may want to promote a chill effect to discourage more aggressive transactions, although, as the ABA has pointed out, the stakes in these transactions of current taxation versus deferral are often very large for taxpayers. *See* ABA Regulations Report, *supra* note 98 at 1721.