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Prepared Testimony of Treasury Tax Legislative Counsel Michael Desmond

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U.S. DEPARTMENT OF THE TREASURY

Press Center



Prepared Testimony of Treasury Tax Legislative Counsel Michael Desmond

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Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means

Washington -- Mr. Chairman, Ranking Member English, and distinguished Members of the Subcommittee:

Thank you for the opportunity to discuss with you today the Federal tax treatment of certain derivative products, including prepaid forward contracts. With the growing complexity and sophistication of our financial markets, the tax treatment of derivatives plays an increasingly important role in the efforts of the Treasury Department and the Internal Revenue Service ("IRS") to administer the nation's tax laws, and we appreciate this Subcommittee's focus on these issues.

The tax treatment of prepaid forward contracts is of continuing interest to the Treasury Department. Last December, we issued Notice 2008-2 (the "Notice"),^[1] announcing that we are considering the subject and requesting public comments with respect to a number of specific issues. The period for submitting formal comments remains open, and the Notice has generated significant discussion on this important issue.

Although it is premature to offer any conclusions or positions with respect to how we might move forward with respect to the issues raised by the Notice, we look forward to continuing to work with this Subcommittee as you consider proposals that would affect the tax treatment of derivatives and, in particular, proposals to change the tax law with respect to prepaid forward contracts. To that end, it may be productive to describe the context in which we have seen this issue arise and some of the challenges we see in addressing it. It may also be helpful to provide some background regarding the Notice in order to clarify the context in which we are considering the issue and to develop a mutual understanding of the issues presented.

General Background Regarding Forward Contracts

Historically, forward contracts developed as a means for parties to hedge against the risk of price fluctuations in ordinary business operations. For example, a manufacturer might enter into a forward contract on steel that is used as a component in its production process to hedge against the risk that the price of steel will rise. For similar reasons, an airline might enter into a forward contract on jet fuel to hedge against the risk of fuel price increases. By fixing the price at which some asset will be acquired (or sold) in the future, a forward contract can reduce the risk of adverse price changes and, thereby, reduce the cost of doing business. Forward contracts, however, are not solely used in hedging transactions. Parties can (and do) use forward contracts to speculate on the future value of a reference asset.

A traditional forward contract is an agreement in which one party (in the "long position") agrees to purchase, and the other party (in the "short position") agrees to sell and deliver, a specific asset (the "reference asset") at a specific time for a specific price (the "forward price"). Generally, the party in the long position will profit from an increase in the price of the reference asset, while the party in the short position will profit from a decrease in the price.

Parties to a forward contract often settle their obligations under the contract with a single, net, cash-settlement payment (rather than through physical delivery of the reference asset and payment of the full forward price). In typical "cash-settled" contracts, at the time the contract settles, the forward price set forth in the contract is compared to the then-current (or "spot") price of the reference asset. If that spot price is less than the forward price, then the long position pays the difference; if that spot price is more than the forward price, then the short position pays the difference.

The forward price for a nonperishable commodity or a financial instrument generally equals the reference asset's spot price at the time the contract is executed, plus the "cost to carry" (or hold) the asset for the term of the contract. "Cost to carry" represents interest (and other costs^[2]) that a party would have to pay if it were to borrow to purchase and "carry" the reference asset during the term of the arrangement.^[3] Consequently, the forward price implicitly includes a component that is calculated by reference to the time value of money – that is, interest. If the time value of money were not properly factored in to the forward price, arbitrageurs would be able to earn risk-free profits.^[4]

Some contracts (referred to as "prepaid forward contracts") require the party in the long position to pay the purchase price upon execution of the contract, rather than on the later delivery date. In these circumstances, the amount paid typically reflects only the spot price of the

asset to which the contract refers (plus any warehousing or similar expenses), but does not reflect a time value component. Again, if this were not the case, arbitrageurs could earn a risk-free profit.

General Background Regarding Taxation of Derivatives

The Internal Revenue Code and Treasury regulations contain a number of specific rules governing the Federal tax treatment of stock, debt, options, traditional forward contracts, futures contracts, certain swaps, and various other financial instruments. Different rules may apply to identical instruments in different contexts. Thus, for example, a forward contract may be taxed differently if it is executed by an investor,[5] a trader,[6] a dealer,[7] or a business hedger.[8] An identical forward contract may also be taxed differently depending on whether it is executed by a domestic or a foreign person,[9] or whether it derives its value from certain reference assets (such as foreign currency).[10] In addition, a single forward contract may involve different types of taxpayers as counterparties on opposite sides of the same contract. Thus, a single forward contract often generates asymmetrical tax consequences for the parties.

The resulting set of complex rules reflects various policy choices that Congress and the Treasury Department have made over the years with respect to the timing of income and loss, the character (capital or ordinary) of income and loss, and the source (domestic or foreign) of income and loss.

Financial innovation challenges the current system of taxing derivatives, because the system generally approaches new financial transactions by attempting to assign them to various categories (of the nature described above) for which there are clearly established rules. These categories are often colloquially referred to as "cubbyholes." Absent clear guidance as to which category a new transaction might fit in to, taxpayers are left to deal with uncertainty in structuring their affairs and the IRS is presented with difficulties in administering the tax law.

Unavoidably, this "cubbyhole" approach results in different tax consequences for economically equivalent transactions. For example, if a "triple-A" rated company issues preferred stock that is required by its terms to be redeemed on a specific date, that stock may be economically indistinguishable from that company's subordinated debt with the same maturity date. For both the company and its investors, however, these two transactions are taxed differently. Financial innovation amplifies this phenomenon (that is, different tax treatment of economically equivalent transactions) by increasing the number of situations in which it materializes. A single "hybrid" instrument that cannot be easily classified under the existing taxonomy may combine traditional instruments such as stock and debt. Alternatively, combinations of separate transactions may produce net cash flows that replicate a traditional instrument, thus creating a "synthetic" version of the traditional one, but with different tax consequences.

The following three examples illustrate this phenomenon in the specific context of prepaid forward contracts:

Example 1. On date 1, X (a hypothetical domestic investor) buys a share of stock of ABC Inc. for \$100. Two years later (on date 2), X sells the stock for its fair market value of \$125.

Example 2. On date 1, X buys a "zero coupon bond"[11] (the "bond") for \$100. The bond was issued by Corp Q on date 1 and matures in two years (on date 2) for \$112, reflecting an interest rate of approximately 6%. On date 1, X also enters into a cash-settled forward contract to purchase a share of stock of ABC Inc. from Y in two years (on date 2) for \$112. Two years later (on date 2), the fair market value of a share of stock of ABC Inc. is \$125. On date 2, X receives a total of \$125, consisting of \$112 from Corp Q in redemption of the bond, and \$13 from Y in settlement of the forward contract.

Example 3. On date 1, X enters into a cash-settled prepaid forward contract to purchase a share of stock of ABC Inc. in two years (on date 2). Pursuant to the contract, X pays Y \$100 on date 1. In exchange, Y agrees to pay X on date 2 the fair market value on that date of a share of stock of ABC Inc. The contract does not require Y to own or acquire any stock of ABC Inc. Two years later (on date 2), the fair market value of a share of stock of ABC Inc. is \$125. On date 2, X receives \$125 from Y in settlement of the forward contract.

Aside from their tax consequences, these transactions are economically equivalent. In each case, X paid \$100 on date 1 and received \$125 on date 2, for an economic return of \$25. However, on an after-tax basis, these transactions differ considerably.

In Example 1, X pays tax on its entire \$25 economic return on a deferred basis (on date 2) at the long-term capital gains rate. This result follows from the current realization-based system of taxation.

In Example 2, X accrues \$12 (attributable to the bond) into taxable income on a current basis and pays tax on these accruals in years 1 and 2 at ordinary income rates. X pays tax on the \$13 attributable to the forward contract on a deferred basis at long-term capital gain rates. This result follows from the respect the current tax system generally affords to the separate transactions (the bond and the forward) and the specific tax rules that apply once each is assigned to a separate category.

What do these principles say about the manner in which Example 3 (the prepaid forward contract) should be taxed? In particular, does current law require X to bifurcate (or does it prevent X from bifurcating) the single contract into separate economic components for tax purposes? As a matter of market practice, investors in X's position in Example 3 typically do not bifurcate. Instead, they generally attempt to assign the transaction to only one of the traditional categories for which the tax system has prescribed rules. Investors in X's position often conclude that the transaction is not indebtedness under common law tax principles. They emphasize that, unlike traditional debt, which guarantees a return of principal, there is a meaningful likelihood that a significant portion of the \$100 amount advanced may not be repaid because the value of ABC Inc. stock may go down. Furthermore, investors in X's position often conclude that their counterparty in

the transaction is not acting as their agent, holding ABC Inc. stock on their behalf, stressing that X cannot be sure whether its counterparty (Y) even owns stock of ABC Inc. during the term of the transaction.

Having concluded that neither the debt nor the agency characterization is proper, investors in X's position generally assert that the transaction should be treated as a forward contract, taxed only upon realization. This result in Example 3 is consistent with the result in Example 1 (where tax is not paid until realization), but not with the result in Example 2 (where the investor is required to pay tax on accrued but unpaid income), even though all three examples involve economically equivalent transactions.

Notice 2008-2

The Treasury Department and the IRS have been aware for some time of the difficult issues raised with respect to the tax treatment of prepaid forward contracts. In 1993, in a preamble to regulations dealing with certain swap transactions, the Treasury Department and IRS first announced that they were studying the tax treatment of prepaid forward contracts and requested public comments. Specific projects to address prepaid forward contracts were placed on the administrative guidance "business plan" in 1993 and again in 2001. To date, however, published guidance has not been issued.[12]

In 2007, the Treasury Department and IRS became aware of an instrument that was beginning to be offered to retail investors in the capital markets that purported to be a prepaid cash-settled forward contract with respect to foreign currency. The offering materials filed with the Securities and Exchange Commission (SEC) suggested that for Federal tax purposes the instrument did not require current income inclusions by investors and had the potential of generating long-term capital gains. In response, Revenue Ruling 2008-1, 2008-2 I.R.B. 248 (Jan. 14, 2008), was released in December 2007, holding that these instruments are foreign-currency-denominated debt under general tax principles, and that investors must accrue currently interest income.

In 2006, we also learned of recent significant growth in the number of prepaid forward contracts being offered to retail investors with respect to reference assets other than foreign currency. Language in the offering documents filed with the SEC with respect to these instruments suggested that they are not debt under general tax principles. In the retail space, these instruments are sometimes referred to as exchange traded notes ("ETNs"). Typically, ETNs differ from the simple situation described in Example 3, above, in that they reference large portfolios of stocks and/or commodities rather than a single stock or asset. These portfolios are periodically redefined and, in the case of stock indices, may pay dividends which are credited to the contract, but are not currently paid to the holder of the contract. These features present unique questions as to whether deferral of tax is appropriate.

Because of the large number of taxpayers potentially affected and their relative level of sophistication, the migration of prepaid forward contracts into the portfolios of retail investors served as an occasion for us to revisit the core issue related to prepaid forward contracts -- whether or not a current accrual of income should be required. We issued the Notice to inform the public that we are continuing to examine this issue and to solicit comments. As the popularity of prepaid forward contracts grows, more taxpayers are affected by the current lack of clarity and need guidance regarding how to compute their tax liability. We were also mindful of the fact that the market segment into which these transactions is expanding is one that is, perhaps, less capable of appreciating the risks associated with this uncertainty.

Although it would be very desirable for us to clarify this area, we have reached no conclusion about how to proceed, about what result should be reached, or about whether we are able to reach that result with administrative guidance.

Thank you Mr. Chairman, Ranking Member English and Members of the Subcommittee for providing an opportunity for us to participate in today's hearing on this important subject. I would be pleased to respond to your questions.

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[1] 2008-2 I.R.B. 252 (Jan. 14, 2008).

[2] For example, the "cost to carry" includes any warehousing, insurance, and similar expenses that a party would have to pay if it were to hold (or "carry") the asset during the term of forward contract. These costs arise more frequently in the context of forward contracts on commodities.

[3] Any expected cash yield on the asset underlying the forward contract (for example, dividends on stock) is typically subtracted from the forward price. (Because it is a benefit, rather than a cost, of holding the asset over the term of the contract, it is like a negative "cost to carry.")

[4] For example, if the forward price were too high (i.e., if it were in excess of the spot price plus the cost to carry, including this time value component), an arbitrageur could borrow at market interest rates to purchase the reference asset at its spot price today and simultaneously take the short position on the forward contract. Similarly, if the forward price were too low (i.e., if it were below the spot price plus the cost to carry, including this time value component), an arbitrageur could short sell the reference asset today (i.e., borrow the asset and sell it in the market for its current price) to generate cash proceeds to purchase a bond paying market interest rates and simultaneously take a long position on the forward contract.

[5] If an investor executes a traditional forward contract with respect to an asset that is a capital asset for that investor, the contract is treated as an "open transaction" for tax purposes -- that is, it has no tax effect until the transaction is ultimately settled. See, e.g., Lucas v.

North Texas Lumber Co., 281 U.S. 11 (1930). If the forward contract is settled by physical delivery of the reference asset, the seller (that is, the short position) recognizes capital gain or loss at the time it delivers the asset. The amount of gain or loss is determined by reference to the seller's basis in the asset and the forward price received. Likewise, the buyer (that is, the long position) takes a basis in the asset equal to the forward price it pays, and realizes capital gain or loss upon its ultimate disposition of the asset. If, instead, the forward contract is cash settled (that is, the "losing" party makes a cash payment), the recipient recognizes capital gain and the payor recognizes a commensurate amount of capital loss at the time the payment is made. See section 1234A. Special rules change these results in certain circumstances (e.g., if the forward contract is part of a straddle (section 1092), a conversion transaction (section 1258), a constructive sale (section 1259), or a constructive ownership transaction (section 1260)).

[6] A "trader" that elects to have section 475(f) apply must "mark to market" the forward contract (that is, treat the position as if it is sold for its fair market value at the end of each tax year) and treat the resulting gain or loss as ordinary (rather than capital) in character.

[7] A "securities dealer" must "mark to market" forward contracts with respect to securities (that is, treat the position as if it is sold for its fair market value at the end of each tax year) and treat the resulting gain or loss as ordinary (rather than capital) in character. A "commodities dealer" may elect this treatment. See section 475.

[8] A "hedger" must match the timing of the gain or loss recognition on the forward contract with the timing of the gain or loss recognition on the item being hedged. See Treas. Reg. §1.446-4. The gain or loss is typically ordinary, so long as appropriate identifications are made. See section 1221(a)(7).

[9] For example, foreign persons are taxed at graduated rates on net income that is "effectively connected" with a U.S. trade or business. See sections 871(b) and 882. In the absence of a U.S. trade or business, foreign persons are generally taxed at a flat 30-percent rate on certain gross income from U.S. sources. See sections 871(a) and 881. Tax treaties often change these results. If the foreign person is a "controlled foreign corporation," the tax consequences to U.S. shareholders depend on a number of complicated variables, such as whether the asset underlying the forward contract is a commodity, and whether it is a hedging transaction.

[10] In certain circumstances, a forward contract on foreign currency is "marked to market." See section 1256. Gain or loss on these contracts is typically ordinary in character, but, in certain circumstances, taxpayers can elect to treat the gain or loss as capital. See section 988.

[11] A zero-coupon bond is a debt security that does not pay interest on a current basis but instead, is issued at a discount to its nominal (or "face") value. (The discount generally reflects the prevailing market interest rate.) For U.S. tax purposes, all holders of bonds that are originally issued with such a discount (such as X, in Example 2) must generally accrue the "original issue discount" into income as interest over the term of the bond. Thus, the holders will have an income tax liability based on this accrued income even though they do not have any current cash flow from the bond. See section 1272.

[12] The IRS and Treasury Department have addressed a very different tax issue in connection with a transaction called a "variable prepaid forward contract." That transaction involves a situation similar to Example 3, except that X plays the role of seller, not buyer, of ABC Inc. stock under a contract. Because X separately owns appreciated ABC Inc. stock, the key tax issue presented is whether the contract and other aspects of the transaction amount to a current sale (or constructive sale) of the stock. (There are meaningful differences between the simplified prepaid forward contract described in Example 3 and typical variable prepaid forward contracts that bear on this key tax issue.) Revenue Ruling 2003-7, 2003-1 C.B. 363 (Feb. 3, 2003), holds that no such sale results from the arrangement described in the ruling. A matter of current controversy between the IRS and certain taxpayers is whether particular transactions are within the scope of the revenue ruling.