

# Treasury and IRS Issue Notice and Revenue Ruling Concerning “Prepaid Forward Contracts” (*i.e.*, Non-Principal-Protected Structured Notes and Similar Instruments)\*

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## I. BACKGROUND.

On December 7, 2007, the Treasury Department (the “Treasury”) and the Internal Revenue Service (the “IRS”) issued Revenue Ruling 2008-1 (the “Revenue Ruling”) and Notice 2008-2 (the “Notice”), both of which address certain tax issues related to “prepaid forward contracts.” The term “prepaid forward contract” is a term used by tax practitioners to characterize a variety of financial instruments, including: “exchange traded notes,” or “ETNs,” and other types of structured notes, such as equity-linked and commodity-linked notes, as well as reverse convertibles, variable stock purchase contracts, mandatory exchangeables, mandatory convertibles, and access notes. The Revenue Ruling and the Notice contemplate that such instruments may become subject to taxation on a current accrual basis at ordinary rates (as opposed to capital gains rates), and raise issues as to how such instruments should be treated for purposes of the U.S. withholding tax rules and international tax rules.

As discussed in more detail below, the Revenue Ruling holds that a particular foreign currency-linked instrument characterized by its issuer as a prepaid forward contract in fact constitutes a debt instrument for U.S. federal income tax purposes under current law. Accordingly, under the Revenue Ruling, the prepaid forward contract will be taxed on a current accrual basis and will be taxed at ordinary rates (as opposed to capital gains rates) in respect of interest accrued and foreign currency gains.

The Notice requests public comments on a comprehensive list of tax policy issues raised by prepaid forward contracts that do not constitute debt instruments under current law. The Notice also raises the possibility that there may be other “prepaid forward contracts” that should be treated as debt instruments under current law.

For purposes of the Notice, a “prepaid forward contract” is any transaction in which an investor makes an initial upfront payment in exchange either for the future delivery of an asset (or group of assets) or a cash payout determined by reference to the value of an asset or to the performance of an index or investment strategy. The Revenue

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Ruling and the Notice appear, to some extent, to be a response to the facts that there have been an increasing number of “prepaid forward contract” instruments issued to retail investors in the form of liquid very long-dated non-principal protected notes that provide investors with the total return on a benchmark index but that pay no current coupons. In addition, some such contracts provide returns linked to relatively active and complicated investment strategies, such as, for example, certain formula-driven indices made up of long and short exposures to a relatively wide variety of assets, or strategies involving “synthetic leverage.”

Investors in instruments characterized as prepaid forward contracts typically, although not invariably, take the position that they are not required to accrue any income other than stated coupons, if any. More generally, it is common for investors to take the position that the returns from a cash-settled prepaid forward contract, other than any current coupons, are capital gains taxable only upon the contract’s maturity, and that the delivery of assets pursuant to the physical settlement of a contract constitutes a purchase of property that does not in and of itself constitute a taxable event. The Revenue Ruling indicates that the Treasury will treat certain prepaid forward contracts as debt instruments, which do not allow deferral of income and limit capital gains treatment. The Notice in turn suggests a concern that prepaid forward contracts that are not debt instruments may permit inappropriate deferral of income and may allow for inappropriate capital gains treatment (and exemption from withholding tax) for returns that economically represent amounts that would have been taxed at ordinary rates (or subject to withholding) had the investor held the underlying assets directly or engaged in the underlying investment strategy directly.

## II. HOLDING AND POTENTIAL SCOPE OF THE REVENUE RULING.

The Revenue Ruling discusses the tax treatment of a three-year transaction in the form of a dollar-denominated note that resembles a prepaid forward contract, in which the investor makes a full upfront payment at the transaction’s inception in exchange for a cash payout at maturity based on: (i) the value of the investor’s initial cash payment adjusted for fluctuations in the euro-dollar exchange rate over the contract’s term (so that the investor is “long” euros), and (ii) a euro-based compounded rate of return.

The Revenue Ruling holds that the contract in question constitutes a euro-denominated debt instrument for U.S. federal income tax purposes, with the result that the instrument is subject to tax on a current-accrual basis and that all income realized by the

investor will be taxed at ordinary rates (as opposed to capital gains rates) to the extent attributable either to interest accruals or foreign currency gains.<sup>1</sup>

In addition, it should be noted that the holding of the Revenue Ruling is not “affected if the [currency contract] is (i) privately offered, (ii) publicly offered, or (iii) traded on an exchange.”

Because the Revenue Ruling is considered to be an interpretation of already-existing law, it effectively has retroactive effect and thus applies to instruments already outstanding in the market. If the IRS and Treasury did choose to characterize other prepaid forward contracts as debt instruments through future revenue rulings, those rulings may also have retroactive effect.

To the extent that the IRS were to hold that other types of prepaid forward contracts (i.e., contracts referencing assets other than foreign currency) constitute debt instruments for tax purposes, those contracts likely would be treated as “contingent payment debt instruments” (“CPDIs”), in which case: (i) all returns from such a contract would be treated as ordinary interest income, and (ii) the investor would be required to accrue income on a current basis by reference to a hypothetical “comparable yield,” which takes into account the expected value of contingent payouts and thus could require current recognition of income (subject to subsequent adjustment in later periods) in excess of amount that actually accrue to the investor currently.

### III. THE NOTICE.

The Notice requests public comment on a range of tax policy issues raised by prepaid forward contracts that are not otherwise properly treated as indebtedness under current law. These policy issues are not new and have been considered (at least in part) in other contexts, such as CPDIs and notional principal contracts. What is new, however, is the Treasury’s focus on prepaid forward contracts. Below is a list of what the authors believe to be the most important aspects of the Notice:

- ***Current Accrual.*** The Notice states that the Treasury and the IRS “are considering whether the parties to a [prepaid forward contract] should be required to include income/expense during the term of the transaction,” again, assuming the transaction is not otherwise already properly classified as debt under current law.

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<sup>1</sup> The Revenue Ruling notes that the returns on the currency contract are net of a “fee” retained by the issuer, and that fact does not affect the conclusion that the contract constitutes a debt instrument for U.S. federal income tax purposes.

- The Notice suggests several possible approaches to achieve a current accrual regime, including:
  - (i) adoption of a mark-to-market methodology;
  - (ii) expansion of the current accrual regime currently applicable to CPDIs;
  - (iii) adoption of regulations that would categorize prepaid forward contracts more generally as debt instruments, and
  - (iv) treatment of prepaid forward contracts as “constructive ownership transactions” under section 1260<sup>2</sup> (in which case the transactions would not actually be taxed on a current basis, but the investor would be required to pay an interest charge in respect of certain deferred income).
- The Notice contemplates that any new accrual regime might apply to instruments that pay current coupons, and asks for comments on how to treat accruals that exceed such coupons and coupons that exceed the accrued income.
- **Character.** The Notice requests comments on the “appropriate character (capital vs. ordinary, and if ordinary, whether interest) of any income accruals required [under a current accrual regime].”
  - The suggestions, referred to in the “Current Accrual” discussion above, that prepaid forward contracts might be treated as CPDIs, or otherwise as debt instruments, or as constructive ownership transactions, all point towards a regime where all (or significant portions) of an investor’s returns under prepaid forward contracts that are currently treated as capital gains could be taxed at ordinary income rates.
- **Issues of Scope.** The Notice requests comments as to the appropriate scope of any future rules or guidance that may be issued, and specifically asks for comments on the following issues:
  - *Does Listing Matter?* Whether it is relevant that a prepaid forward contract is traded on a futures exchange or a securities exchange. (As discussed above, the Revenue Ruling explicitly states that listing or public trading of the

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<sup>2</sup> Unless indicated otherwise, all section references are to the Internal Revenue Code of 1986, as amended, or to Treasury regulations promulgated thereunder.

currency contract is irrelevant to the Revenue Ruling's central holding.) In this regard, the Notice acknowledges that certain exchange-traded contracts are already subject to a mark-to-market regime under section 1256, perhaps implying that other exchange-traded instruments may be brought under that regime.

- *Does It Matter What the Underlying Assets Are?* The Notice asks whether tax treatment should vary depending on the nature of the underlying assets and gives “stocks vs. commodities” as an example.
  - It appears that, by specifically mentioning “stocks vs. commodities,” the Notice could be suggesting that contracts on financial assets providing for current payouts (*e.g.*, dividend-paying stock) might provide more opportunity for inappropriate income deferral than contracts on assets, such as commodities, that do not provide for current returns.
  - Similarly, the Notice recognizes that any future current accrual regime should not apply to “routine commercial transactions involving property sales in the ordinary channels of commerce.” However, the Notice does not suggest how to define such routine commercial transactions.
  - The Notice does not suggest that any special or different treatment be accorded to instruments linked to an issuer's own stock. Thus, it is possible that accrual of income and expense could be required with respect to such instruments.
- *Should Future Rules or Guidance Also Address Instruments Other than Prepaid Forward Contracts?* The Notice expresses an interest in “identifying arrangements similar to prepaid forward contracts that should be accorded tax treatment similar to that of prepaid forward contracts.”

- ***International Aspects.***

- *Withholding Tax.* The Notice raises the issue of whether, and to what degree, payments on prepaid forward contracts held by foreign investors, as well as deemed accruals in respect of such contracts, should be subject to U.S. withholding tax. The Notice suggests a concern that prepaid forward contracts may give rise to an avoidance of withholding tax in cases where withholding would have applied to a direct investment in the underlying asset.

- *Anti-deferral rules; Subpart F.* The Notice also raises the issues of: (i) how accruals in respect of prepaid forward contracts in the hands of a “controlled foreign corporation” (“CFC”) should be treated for purposes of the anti-deferral regime of subpart F of the Code (*i.e.*, whether, and under what theory, such accruals should be viewed as “Subpart F Income” taxable currently to U.S. shareholders of the CFC), and (ii) whether, and in what circumstances, an investment by a CFC in a prepaid forward contract could constitute an investment in “United States property” for purposes of section 956, in which case such an investment could be taxed currently as a dividend to the shareholders of the CFC.
  
- ***Expenses.***
  - *Should expenses on prepaid forward contracts be treated as interest?* The Notice suggests in several places, including the discussion of international rules, that current accruals on prepaid forward contracts might be treated (at least to some extent) as interest on indebtedness.
    - That treatment would raise the issue of whether deemed accrued expenses in connection with prepaid forward contracts might be subject to allocation against U.S.-source and foreign-source income under the “fungibility of money” rules of Treasury regulation section 1.861-9T. In such a case, prepaid forward contracts issued by U.S. corporations that are part of a larger international corporate group (*e.g.*, U.S. financial institutions with significant “structured note programs”) could find that the contracts had an impact on foreign tax credit planning.
    - In addition, treatment of deemed accrued expenses as interest would subject those expenses to currently-applicable limits on interest expense deductions, including the investment interest expense rules applicable to individuals, the straddle rules, and the interest disallowance and capitalization rules of section 163(I) with respect to instruments linked to stock.
  
- ***Effective Date; Transition Rules.*** The Notice specifically leaves this issue open, so that it is uncertain whether, or to what extent, future rules or guidance could apply to instruments that already are outstanding, or otherwise effectively apply on some sort of retroactive basis.

- ***Deadline for Comments.*** The Notice requests that all public comments on the issues described above be submitted to the IRS no later than *May 13, 2008*.

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