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Client Alert

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Lending of Stock Underlying a Variable Prepaid Forward Contract Treated as a Taxable Sale of the Stock

The ability to lend stock that is the subject of a variable prepaid forward contract and avoid a taxable sale of the stock has been put into issue by the Internal Revenue Service.

In a recent "Law and Analysis" section of an IRS technical advice memorandum ("TAM") that is presently circulating (although the complete TAM has not as yet been formally published), the Internal Revenue Service concludes that the execution of a variable prepaid forward contract together with the simultaneous lending of the underlying shares to the same counterparty will be treated as a taxable sale of the underlying stock.

The critical factor in the Service's analysis appears to be the fact that the stock lending transaction coupled with the variable prepaid contract provided the counterparty with the unrestricted use of the shares and eliminated the risk of loss and reduced the possibility of gain to the taxpayer. The presence of both of these elements led the Service to conclude that the transaction constituted a taxable sale. The Service also supported its conclusion with an analysis that the totality of the legal relationships between the parties had the effect of requiring that the prepaid forward contract be satisfied only with the pledged and loaned shares, rather than allowing the option of a cash settlement on the delivery date.

The portion of the TAM that is publicly available is limited to the law and analysis section. A description of the facts of the case and, in particular, the provisions of the various agreements between the parties are not yet available. Therefore, the ability to provide a detailed analysis of the reasoning of the TAM as applied to the specific facts of the case is necessarily constrained.

Variable Prepaid Forward Contracts

A variable prepaid forward contract is a transaction in which a holder of stock generally receives cash upon execution of the contract and in return is obligated to deliver at a future date a number of shares to be determined by a formula. Typically, under such a formula, the number of shares to be delivered varies significantly depending on the value of the shares on the delivery date. In addition, the stockholder typically has the right to deliver cash equal to the value of the stock that the stockholder would otherwise be required to deliver under the formula.

As an illustration of a variable prepaid forward contract, assume an individual shareholder holds 100 shares of publicly traded stock. The shareholder's basis in the shares is less than $20. On December 15, 2005, the shareholder enters into an arm's length agreement with an investment bank, at which time a share has a fair market value of $20. The shareholder receives cash upon execution of the agreement. In return, the shareholder becomes obligated to deliver to the investment bank on December 15, 2008 (the "Delivery Date"), a number of shares to be determined by a formula. Under the formula, if the market price of a share is less than $20 on the Delivery Date, the investment bank will receive 100 shares. If the market price of a share is at least $20 and no more than $25 on the Delivery Date, the investment bank will receive a number of shares having a total market value equal to $2000. If the market price of a share exceeds $25 on the Delivery Date, the investment bank will receive 80 shares. In addition, the shareholder has the right to deliver to the investment bank on the Delivery Date cash equal to the value of the stock that the shareholder would otherwise be required to deliver under the formula.

In order to secure the stockholder's obligations under the agreement, the stockholder pledges the maximum number of shares that could be required to be delivered. Generally, the stockholder effects this pledge by transferring the shares in trust to a third party trustee. Under the declaration of trust, the stockholder retains the right to vote the pledged shares and to receive dividends. The Service previously has held that such an arrangement is not considered to be a taxable disposition of the stock by the stockholder upon the execution of the contract. See Rev. Rul. 2003-7, 2003-1 C.B. 363.

In the TAM, it appears that in addition to the standard factual scenario described above, the counterparty, because it needed to hedge its exposure to a large drop in price of the stock, also required the shareholder to lend it all of the pledged stock.

The Service concluded that the share lending agreement, viewed in conjunction with all of the legal relationships between the taxpayer and the counterparty, had the effect of transferring an unfettered right to the shares to the counterparty together with eliminating risk of loss and reducing the opportunity for gain by the taxpayer. The Service relied on the counterparty's use of the pledged shares to hedge the transaction, thereby eliminating the taxpayer's ability to reacquire the shares, as well as contractual provisions that the Service interpreted as requiring the taxpayer to satisfy the variable prepaid forward contract with shares, eliminating the possibility of settling the contract in cash. The Service also pointed to certain acceleration and offset provisions of the agreements that would occur and effectuate the transfer of the pledged (and loaned) shares to the counterparty if the taxpayer attempted to recover the loaned shares. In addition, the Service noted that the counterparty was not required to post collateral for the value of the borrowed shares.

Therefore, under the facts and directives in the TAM, the taxpayer was deemed to have transferred ownership of the pledged shares when the shares were loaned from the pledged accounts and did not retain significant indicia of ownership to prevent a taxable sale for federal income tax purposes.

The Service addressed two other issues in the TAM: the possible applications to the transaction of Section 1058 and the open transaction doctrine.

Section 1058. The Service found that the original stockholder did not qualify for nonrecognition under Section 1058 of the Internal Revenue Code. Under Section 1058, certain lending arrangements qualify for nonrecognition only if the arrangement does not reduce the lender's risk of loss or opportunity for gain and does not reduce the ability, at any time, for the lender to regain possession of the loaned property. Under the facts of the TAM, the original stockholder had given up all risk of loss and most of its opportunity for gain. In addition, the Service found that it was doubtful that the stockholder could regain possession of the loaned shares because doing so might accelerate the delivery date under the forward contract and allow the counterparty to offset the shares it was due under the forward contract by the shares it had borrowed. Accordingly, the Service found that Section 1058 did not apply.

Open transaction treatment. Under the open transaction doctrine, in certain sales or exchanges, the recognition of gain is deferred until the amount of gain can be reasonably ascertained. The open transaction doctrine is applied only when it is not possible to determine the value of either of the assets exchanged. Under the facts of the TAM, although the fair market value of all of the elements of the variable prepaid forward contract may not be readily ascertainable, the fair market value of the publicly traded stock transferred was readily ascertainable. The fair market value of the taxpayer's economic rights under the variable prepaid forward contract, i.e., the cash received plus the contingent right to a return of some shares (or its cash equivalent) based on the delivery formula, was deemed to equal the fair market value of the shares transferred, and therefore the open transaction doctrine was not applicable.

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