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Towards Equal Tax Treatment of Economically Equivalent Financial Instruments: Proposals for Taxing Prepaid Forward Contracts, Equity Swaps, and Certain Contingent Debt Instruments

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I. INTRODUCTION

In recent years, many commentators have debated the merits of various proposals regarding the taxation of financial derivatives.[1] The Internal Revenue Service (the "Service") has, in the case of certain derivatives, attempted to settle that debate by issuing regulations that address the taxation of notional principal contracts and contingent debt instruments.[2] The debate, however, continues, mainly because many financial instruments are economically equivalent to one another and yet give rise to different tax results.[3] Rather than proposing changes in the tax treatment of specific instruments, commentators now call for the complete overhaul of all of the rules governing the taxation of all financial instruments. While many of those proposals certainly have merit, it seems as though the Congress is not likely to completely overhaul the Internal Revenue Code (the "Code") any time soon.

A good deal of the debate concerning the taxation of financial derivatives has centered on the corporations that issue these derivatives (the "issuers").[4] In the author's opinion, many of the problems and abuses cited by those commentators should be solved not by focusing on the issuer, but by focusing on the investor who purchases these derivatives. That conclusion stems from the following four facts: First, issuers develop complex financial instruments such as contingent debt instruments in order to accommodate the demands of investors.[5] Second, issuers of complex financial instruments often enter into hedging transactions that leave them in the same position in which they would have been, with respect to both economic result and tax treatment, had they issued traditional fixed or floating rate debt instruments. Third, investors will be taxed differently depending on the type of derivative that they purchase. Fourth, so long as issuers can save money by issuing

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1. The term "derivative" encompasses financial instruments whose value varies in accordance with the movement in value of some other asset or index. KPMG, Solving the Mystery of Derivatives 1 (1994). For example, an option on X Co. stock is a derivative, because the value of the option will vary in accordance with the value of X Co. stock, which is the underlying property. See id. at 6. See generally Roberta Romano, A Thumbnail Sketch of Derivative Securities and Their Regulation, 55 Md. L. Rev. 1 (1996) (discussing and analyzing various derivative instruments).

2. See infra notes 203-207 and accompanying text. Hereafter, the term "Service" will include the Treasury Department.

3. See infra Parts II-IV.

4. E.g., Edward D. Kleinbard, Beyond Good and Evil Debt (And Debt Hedges): A Cost of Capital Allowance System, 67 Taxes 943 (1989) (proposing overhaul of rules pertaining to issuers of contingent debt instruments); Lee A. Sheppard, Adding PEP to the Constructive Sale Debate, 70 Tax Notes 1592 (Mar. 18, 1996) [hereinafter Sheppard, Adding PEP]; Lee A. Sheppard, Things That Go Bump in the Portfolio, News Analysis, 60 Tax Notes 1423 (Sept. 13, 1993) [hereinafter Sheppard, Things That Go Bump].

5. See infra notes 69-71 and accompanying text.

financial derivatives such as contingent debt instruments, they will continue to do so. Thus, issuers usually design derivatives to save money by accommodating a particular investor profile. In light of that fact, the government should focus its reform efforts on investors.

A good deal of the above mentioned debate revolves around the appropriate classification and taxation of three derivatives: prepaid forward contracts; certain contingent debt instruments ("CDIs"); and equity swaps, which are one type of notional principal contract. A prepaid forward contract is an executory contract that (1) entitles the purchaser to delivery of the underlying property on a particular date in the future, and (2) requires the purchaser to pay for the underlying property at the time the contract is executed.[6] A contingent debt instrument, in the most basic terms, is a promissory note, the repayment of the principal and/or interest on which is contingent upon the value of the underlying property.[7] An equity swap is, in the most basic terms, a bilateral contract that provides for periodic payments which replicate the financial returns generated by an ownership interest in the underlying property.[8]

Each of the above three instruments possess the same economic characteristics. The first two instruments expose the investor to identical credit risks (assuming they are purchased from the same counterparty), while the credit risk attendant to equity swaps is reduced.[9] Each of those instruments is, however, taxed differently.[10]

The character, timing, and source rules applicable to forward contracts have been established. For the most part, the tax rules applicable to cash-settled forward contracts have also been established. Prepaid forward contracts, as discussed below, are but one type of forward contract. As discussed below, however, there does not currently exist a coherent set of rules governing the taxation of cash settled, *prepaid* forward contracts which have a capital asset as the underlying property. Instead, a patchwork system of rules applicable to each derivative fitting that description has evolved.

This patchwork system simply creates as many discontinuities as it resolves. Perhaps that is why so many commentators now call for the complete overhaul of the tax rules applicable to financial derivatives. Until that overhaul occurs, however, we need to develop an interim system that synchronizes, to the maximum extent possible, the tax treatment of economically equivalent derivatives. As a necessary first step in developing that

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6. See infra notes 25-28 and accompanying text.

7. Regs. § 1.1275-4(a)(1).

8. See infra notes 96-100 and accompanying text.

9. The use of periodic payments to reduce credit risk by parties to an equity swap is discussed below in note 102.

10. See infra Parts II-IV.

interim system, we need to construct a coherent set of rules governing the taxation of prepaid forward contracts, particularly those prepaid forward contracts that are settled in cash. Once we do that, we need to classify as prepaid forward contracts all financial derivatives that are economically equivalent to prepaid forward contracts and which have a capital asset as the underlying property. Finally, this interim solution must: (1) contain practical rules, (2) produce sound results from the standpoint of tax policy, (3) work within the debt/equity and capital/ordinary distinctions, and (4) not require the Service to withdraw or rewrite existing regulations. Although an interim solution is by definition imperfect, we need to cure as many tax discontinuities as possible while keeping in mind that a complete overhaul of the Code is, for the time being, not an option.

This article is thus intended to: (1) develop a set of rules governing the taxation of prepaid forward contracts, with particular emphasis on prepaid forward contracts that are settled in cash; and (2) develop a set of rules that accords identical tax treatment to those forward contracts and derivatives, such as equity swaps and certain CDIs, that are economically equivalent to prepaid forward contracts.

This article is divided into five parts. Part II will provide the reader with a brief overview and critique of the tax treatment of capital assets, option contracts, and forward contracts. Part III will: (1) explore the past and present tax treatment of CDIs; and (2) analyze the tax treatment of notional principal contracts, which is the class of derivatives into which equity swaps fall. Part IV will analyze the equivalencies in economic characteristics and the discrepancies in tax treatment among the financial instruments discussed in Parts II and III. Part V will: (1) offer recommendations as to the proper tax treatment of prepaid forward contracts, certain CDIs, and equity swaps; (2) analyze the effects of these recommendations; and (3) address their shortcomings.

II. BACKGROUND ON DERIVATIVES

This section serves two purposes. First, this section provides the reader with background information on the legal rights and economic characteristics of the two "basic" derivatives that are relevant to the instant discussion—forward contracts and options. Second, this section analyzes the tax treatment of these two types of derivatives.

As will be discussed below, the derivatives upon which this article focuses produce economic returns that are identical to the economic returns generated by ownership interests in capital assets. Thus, one must, in order to analyze the tax treatment of those derivatives, review the economic rights and tax treatment generated by ownership interests in capital assets.

A. *Capital Assets in General*

1. *Income Generated by the Asset: Timing, Character, and Source.*—The owner of a capital asset recognizes ordinary income on the receipt of money, such as rent or dividends, generated by that asset.[11] The source of dividend income is generally determined by reference to the nationality of the payor corporation.[12] The source of rental income is generally determined by reference to the location of the property that generated the rental income.[13] Section 871(a) imposes a withholding tax of 30% on U.S. source dividend and rental income received by nonresident alien individuals.[14]

2. *Sale: Timing, Character, and Source.*—When a taxpayer sells or exchanges a capital asset, she realizes and, subject to exceptions not relevant here,[15] recognizes capital gain or loss in an amount equal to the difference between the amount realized on the sale or exchange and the adjusted basis of that capital asset.[16] As a general matter, the gain or loss on the sale or exchange of personal property will be sourced to the taxpayer's country of residence.[17] If, however, a nonresident alien individual sells an "interest in real property" located in the United States, then the gain or loss on that sale will be sourced in the United States.[18] If that sale of real property produces a gain, that gain will be subject to U.S. withholding tax under sections 871 and 1441.[19]

In certain instances, items of loss from the sale of a capital asset may be deferred under the rules contained in section 1092.[20]

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11. IRC § 61(a)(7). Dividends do not qualify for capital gains treatment because § 1222 states that, in order to obtain capital gain treatment, a taxpayer must sell or exchange a capital asset.

12. See IRC § 861(a)(2). For example, dividends paid by a U.S. corporation are generally U.S. source income.

13. IRC § 861(a)(4).

14. IRC §§ 871(a)(1)(A); 1441.

15. E.g., IRC §§ 351, 721, 1031.

16. IRC §§ 1001, 1221, 1222. The gain or loss will be characterized as long term capital if the taxpayer held that asset for more than one year. IRC § 1222(3), (4). If the taxpayer held the asset for less than one year, then the gain or loss will be characterized as short term capital. IRC § 1222(1), (2).

17. IRC § 865(a).

18. IRC § 897(a)(1)(A). The term "interest in real property" includes fee ownership of land, options to acquire land, and "any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property." Regs. § 1.897-1(c)(1), (d)(2)(i).

19. IRC § 871(a).

20. See infra notes 180-186 and accompanying text.

B. *Forward Contracts*

1. *Introduction.*—A forward contract is a privately-negotiated, unregulated executory contract that entitles the purchaser to delivery of an asset at some time in the future.[21] A forward contract contains a fixed price term (the "forward price") and a fixed delivery date (the "forward date").[22] Some taxpayers enter into forward contracts in order to eliminate the risk of movement in the price of an asset that the taxpayer will have to purchase or sell at some point in the future.

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21. See Clifford W. Smith, Jr., et al., Managing Financial Risk 45 (1990). Forward contracts are identical in form to futures contracts. Futures contracts, like forward contracts, obligate a purchaser to purchase a specified asset, and a seller to sell a specified asset, at a particular price on a particular date in the future. Id. at 46. There are, however, for purposes of this article, two material differences between forward contracts and futures contracts. First, the purchaser of a futures contract is subject to less credit risk than the purchaser of a forward contract. That is because, as a futures contract increases in value, that increase is conveyed to that purchaser *on the same day on which the increase occurs.* Id. That is, futures contracts are "marked-to-market daily." Id. That increase in value is conveyed to the purchaser through the use of a margin account. Id. at 47. A margin account consists of deposits (usually of cash) that both parties to a futures contract must make in order to participate in the futures market. Perry J. Kaufman, Handbook of Futures Markets: Commodity, Financial, Stock Index, and Options, 2-10 (1984). As a purchaser's contract increases in value, the futures exchange will add that increase to the purchaser's margin account. Likewise, if a purchaser's contract decreases in value on a particular day, the futures exchange will subtract an amount of money equal to that decrease from the purchaser's account and then add that same amount of money to the margin account of the purchaser's counterparty. Smith et al., supra, at 47. Thus, a futures contract is actually a series of cash-settled forward contracts. That is, in a futures contract, the parties, in essence, enter into a forward contract on day 1, settle that contract on day 2, enter into a new contract on day 3 that has the same price and delivery terms as the contract executed on day 1, and then repeat those steps over and over until the delivery date arrives. See Smith et al., supra, at 47. As will be discussed below, futures contracts are practically identical in form and substance to commodity swaps. See infra notes 103-106 and accompanying text.

The other difference between forward contracts and futures contracts is that futures contracts are subject to § 1256. Congress enacted § 1256 in part because it viewed the mark-to-market system employed by the futures market as giving rise to constructive receipt of income on a daily basis. See S. Rep. No. 144, 97th Cong., 1st Sess. 156 (1981), reprinted in 1981 U.S.C.C.A.N. 105, 255. Congress felt that the reporting of that income should not be deferred in light of the fact that the purchaser of a futures contract can withdraw increases to her margin account to the extent that her margin account balance exceeds a certain minimum established by the futures exchange. See id. The constitutionality of § 1256 was sustained in Murphy v. United States, 992 F.2d 929 (9th Cir. 1993), on the ground that a purchaser of a futures contract, by virtue of the margin account system, constructively receives income on the futures contract during each taxable year.

22. See Smith et al., supra note 21, at 45.

Example. **Part 1:** Jack is a wheat farmer. He plans to harvest and sell 1,000 bushels of wheat in 9 months. Jack is concerned that the sale price of wheat may go down in the next 9 months. In order to insulate himself from a decline in the sale price of wheat, Jack agrees to sell his entire wheat harvest to Jill for $10 a bushel, with delivery in 9 months. Jack has insulated himself from any movement in the sale price of wheat because, regardless of any increase or decrease in the price of wheat, Jack has the right to sell his wheat for $10 a bushel.

Part 2: Jill owns a bread company which purchases 1,000 bushels of wheat each year. Jill knows that she will need to purchase wheat in 9 months and believes that the price of wheat will *increase* in the next 9 months. Therefore, in order to lock in the purchase price of wheat, Jill agrees to purchase all of Jack's wheat for $10 a bushel. Jill has insulated herself from any movement in the purchase price of wheat because, regardless of any changes in the price of wheat, she has the right to purchase wheat at a price of $10 a bushel.

In the above example, Jack will benefit economically from a downward movement in the price of wheat. For example, if the price of wheat declines to $5 a bushel, Jack will be able, nonetheless, to sell that wheat at a price of $10 a bushel. Jack will suffer an economic loss if the price of wheat increases beyond $10 a bushel. In that case, Jack will be forced to sell wheat at a price below its fair market value. Jill will benefit economically from an increase in the price of wheat. For example, if the price of wheat increases to $20 a bushel, Jill will be able to purchase wheat for $10 a bushel. Jill will suffer an economic loss if the price of wheat decreases below $10 a bushel. In that case, Jill will have to purchase wheat at a price in excess of its fair market value.

In tax parlance, Jack's position is known as a "short forward contract," which is economically equivalent to selling the underlying property.[23] Jill's position is known as a "long forward contract," which is economically equivalent to owning the underlying property.[24]

Unlike Jack and Jill, who entered into a forward contract to guard against price fluctuations in a business asset, some taxpayers enter into forward contracts to speculate about the movement in the value of a particular asset.

Example. John, who is a law professor, is married to Jane, who is a professional meteorologist. Jane believes that there will be a devastating drought in the Midwest United States in the next 18 months.

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23. See Smith et al., supra note 21, at 45.
24. See Smith et al., supra note 21, at 45.

> John accordingly believes that the price of wheat will skyrocket once the drought destroys most wheat crops. The forward price of a two year forward contract on wheat is currently $15 a bushel. John believes that that price could easily increase to $50 a bushel should the drought be as severe as Jane predicts. Therefore, John enters into a forward contract to purchase 10,000 bushels of wheat in two years at a price of $10 a bushel.

Parties can enter into a forward contract using any asset as the underlying property. For example, if a real estate developer believes that the government is going to build a major road in a certain area in the next five years, she can enter into five-year forward contracts to purchase commercial real estate in that area.

One must remember that the parties to a forward contract can settle their obligations under the forward contract in cash. For example, if Jack and Jill decided to settle their forward contract in cash: (1) Jill would pay Jack $10,000 on the forward date (1,000 bushels of wheat x $10 a bushel); and (2) Jack would simultaneously pay Jill an amount of money equal to the product of the prevailing spot (current) price of a bushel of wheat and 1,000 (the number of bushels he agreed to sell). In practice, Jack and Jill would net their payments, and the party that stands to lose economically would make a payment to the counterparty equal to the difference between the spot price of the underlying property and the forward price of the contract.

> *Example.* On the forward date of the forward contract between Jack and Jill, wheat is trading at a price of $20 a bushel. The forward price of that contract was $10 a bushel, and the contract called for the delivery of 1,000 bushels of wheat. In order to settle the contract in cash, Jill must pay Jack $10,000 ($10 forward price x 1,000 bushels) and Jack must pay Jill $20,000 ($20 spot price x 1,000 bushels). Rather than exchange checks, Jack pays Jill $10,000. That amount represents Jack's economic loss on the transaction and Jill's economic gain on the transaction.

One must also remember that the parties to a forward contract can agree in advance to settle their obligations in cash (a "cash-settled forward contract"). For example, John (our law professor) would most likely enter into a cash-settled forward contract, because a law professor would probably be unwilling to take delivery of 10,000 bushels of wheat. That analysis indicates that, at the inception of a cash-settled forward contract, neither party to that contract needs to own the underlying property or have any intention of ever acquiring it. Hence, taxpayers can use cash-settled forward contracts as bets. That is, instead of betting on the outcome of the next major sporting event, taxpayers can bet on the future values of various assets.

2. *Pricing of Forward Contracts.*—The forward price is generally determined under a "cash and carry" model. The parties add to the current spot price of the underlying property: (1) the costs that the seller will incur in holding the underlying property until the date of delivery (i.e., insurance, storage, and interest), and (2) any anticipated movement in the spot price of the underlying property.[25]

The purchaser of a forward contract typically has the right to extinguish her obligation to pay the forward price on the forward date by making a lump sum payment of a lesser amount of money on the date the forward contract is executed. That arrangement will be referred to in this article as a "prepaid forward contract."

Ignoring foregone interest on alternative investments, the purchaser of a prepaid forward contract will pay less money out-of-pocket than the pur-

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25. The underlying assumption of the cash and carry pricing model is that, if an investor wishes to purchase the underlying property at some time in the future, she has two choices. First, she can purchase that property at today's spot price and then store it until that time in the future. Second, she can wait until that time arrives and purchase the underlying for the then-prevailing spot price of the underlying. The first alternative requires that investor to incur the costs of storing and insuring the underlying property. The second alternative subjects the investor to changes in the spot price of the underlying property.

The interest component of the price term indicates that, in a sense, the purchaser of a forward contract receives valuable property (viz., a forward contract) for which she did not pay money. That is, that purchaser received that contract on credit from the seller of the contract, and must accordingly pay interest on that loan. See Gregory May, Flying on Instruments: Synthetic Investments and Withholding Tax Avoidance, 73 Tax Notes 1225, 1226 (Dec. 9, 1996) ("The buyer under a forward contract has the right to receive property and the obligation to pay the purchase price. Between the contract date and the forward date, the buyer has the use of his money, and the seller receives [income] . . . from the property. The forward price reflects those facts. In theory, it should be the current fair market value of the property plus *interest on the implicit loan that the seller extends to the buyer* and minus the [income from the property] . . . that the buyer concedes to the seller.") (emphasis added). The existence of the implicit loan is confirmed by the fact that the purchaser of a forward contract receives a *basis* in that contract. Section 1012 provides that the basis of property is its cost. The cost of property includes funds expended for the purchase of property, regardless of the source of these funds, even funds borrowed from the seller of the property by way of a purchase on credit. See, e.g., Mayerson v. Commissioner, 47 T.C. 340, 349 (1966) ("[I]t is well accepted that a purchase-money debt obligation for part of the price will be included in basis. This is necessary in order to equate a purchase-money mortgage situation with the situation in which the buyer borrows the full amount of the purchase price from a third party and pays the seller in cash."). A purchaser of a nonprepaid forward contract does not advance money in exchange for the contract. Thus, if one is to treat that purchaser as having anything other than a zero-basis in that contract, one must also acknowledge the existence of a loan from the seller of the contract to that purchaser.

Another way to think about the interest component is to view the seller of the forward contract as having incurred interest expense in order to hold the underlying property until the forward date.

chaser of a nonprepaid forward contract. For example, if the forward price in a two-year forward contract on a barrel of oil is $20, a purchaser may be able to purchase that contract with an immediate payment of $18. That is, the purchaser can either (1) pay $18 today and receive one barrel of oil in two years, or (2) pay $20 two years from now and then receive one barrel of oil.

Put in these terms, a prepaid forward contract looks very much like a loan from the purchaser to the seller accompanied by a nonprepaid forward contract between the purchaser and the seller.[26] That is because the purchaser of the prepaid forward contract in the above example incurs an obligation to make a $20 payment on the forward date and makes preparations to satisfy that obligation by depositing a lesser sum of money with the seller. That conclusion is supported by the fact that the forward price is determined by reference to the spot price and carrying costs of the underlying property, neither of which decrease *as the result of* a prepayment. Thus, any "discount" that the purchaser receives by virtue of the prepayment must necessarily represent interest received by the purchaser in exchange for letting the seller use her money between the date of the prepayment and the forward date.[27] Put differently, the purchaser decided that she could make more money ($2 after tax in the above example) by lending her cash to the seller than she could make through other investments.[28]

Under a cash-settled forward contract, the purchaser of the contract is only entitled to receive a payment on the forward date equal to the spot price of the underlying property. Thus, in a cash-settled, prepaid forward contract, the purchaser makes a payment today and receives the right to a payment on the forward date equal to the prevailing spot price of the underlying property. A cash-settled, prepaid forward contract, therefore, looks like a loan from the "purchaser" to the "seller," the repayment of which is

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26. See David A. Weisbach, Tax Responses to Financial Contract Innovation, 50 Tax L. Rev. 491, 498 (1995). The existence of a loan becomes readily apparent when one realizes that the seller, by receiving the prepayment from the buyer, has eliminated the credit risk of the buyer. That is, the seller need not worry that the buyer will not perform on the forward date.

27. Interest is defined as payment received in return for the use of borrowed money. See Deputy v. DuPont, 308 U.S. 488, 497 (1940); Old Colony R.R. v. Commissioner, 284 U.S. 552, 560 (1932).

28. For example, assume that X wishes to enter into a one-year forward contract calling for delivery of one barrel of oil. Y informs X that the price term of that contract is $20. X currently has $18 in her possession. If X enters into that forward contract today, she will have to figure out a way to turn that $18 into $20 in one year. If X determines that she may not be able to earn over 10% *after tax* through the other investments available to her, she can simply lend the $18 to Y in exchange for $2 of interest. When Y "repays" the $18 of principal and $2 of interest to X, X will simultaneously transfer that $20 to Y in satisfaction of her obligations under the forward contract.

wholly contingent upon the spot price of the underlying property on the forward date. As will be discussed below, there exists a whole class of CDIs that are practically identical to cash-settled, prepaid forward contracts in both form and economic substance.

3. *Taxation of Forward Contracts*

a. *Timing and Character.*—The tax treatment of forward contracts varies in accordance with two factors: (1) the method by which the parties terminate their rights or obligations under the forward contract, and (2) the nature of the underlying property in the hands of the taxpayer in question. Under current law, the tax treatment of a prepaid forward contract does not vary from the tax treatment of a nonprepaid forward contract.[29] That is, the tax system does not take account of the fact that a portion of the money (or, if the purchaser takes delivery of the underlying property, a portion of the value of that property) received by the purchaser of a prepaid forward contract is, in substance, interest.[30]

There are four ways for a taxpayer to terminate her rights or obligations under a forward contract, only two of which are relevant here: (1) The purchaser can take delivery of the underlying property,[31] (2) the parties can enter into offsetting contracts,[32] (3) the parties can sell or assign their rights in the forward contract, and (4) the parties can settle the contract in cash (i.e., the losing party can make a termination payment to her counterparty).

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29. See Weisbach, supra note 26, at 498.

30. Some government officials believe that the time value component of prepaid forwards is already taxable as interest, but other government officials disagree. Juliann Avakian Martin, IRS Attempting to Identify Time-Value-of-Money in Hybrids, 66 Tax Notes 1767 (Mar. 20, 1995) ("[T]here is no consensus among government officials [regarding the treatment of the time value component of prepaid forward contracts] . . . . Some believe that, even without regulations, a prepaid forward contract is, in part, debt that should generate interest income and deductions. Others believe that regulations are needed allowing this treatment.").

31. If the seller delivers the underlying property to the purchaser, then the seller recognizes gain or loss under § 1001 at the time she delivers that property. The character of the gain or loss will depend on the nature of the underlying property in the hands of the seller. IRC § 1222. The purchaser in a forward contract takes a basis in the underlying property equal to the purchase price of that property. IRC § 1012.

32. If the parties enter into offsetting contracts, then the parties are treated as having consummated back-to-back sales of the same asset. They will recognize gain or loss accordingly under § 1001.

Example. X and A enter into a forward contract that obligates X to purchase one barrel of oil on July 1, 1998, for $20. The price of oil on July 1, 1998, turns out to be $10. On that date, X and A enter into an offsetting contract under which X agrees to sell one barrel of oil to A for $10. Thus, X purchased a barrel of oil from A for $20, and then immediately sold that barrel of oil to A for $10. Thus, X recognizes a $10 loss, and A recognizes a $10 gain.

If one party sells or assigns her rights under the forward contract, she will recognize gain or loss at the time of the sale or assignment of the contract.[33] The character of that gain or loss will turn on the nature of the contract in the hands of the particular taxpayer.[34]

The character of the gain or loss recognized upon the cash settlement of a forward contract will be capital if the underlying property would qualify as a capital asset in the hands of the taxpayer in question.[35]

In certain instances, items of loss from forward contracts may be deferred under section 1092.[36]

b. *Source.*—Forward contracts are personal property in the hands of most investors.[37] The source of income from the sale of personal property is determined by reference to the residence of the owner of that property.[38] Thus, a foreign investor who sells a forward contract,[39] or otherwise terminates her rights or obligations thereunder,[40] will normally recognize foreign source income[41] on which she will not pay U.S. tax.[42] The exception to that rule applies to long forward contracts pertaining to U.S. real property; those forward contracts generate U.S. source income.[43]

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33. IRC § 1001. The question of whether the counterparty of the person who assigned the contract will recognize gain or loss under Cottage Savings, Inc. v. Commissioner, 499 U.S. 554 (1991), is beyond the scope of this article.

34. IRC § 1222.

35. IRC § 1234A. As this article was about to go to press, the President signed into law the Taxpayer Relief Act of 1997, contained in H.R. 2014, which, among other things, contained an amendment to IRC § 1234A. That amendment eliminated the reference to § 1092(d) and made § 1234A applicable to *all* property. Taxpayer Relief Act of 1997, H.R. 2014 § 1003(a)(1), reprinted in 46 Highlights & Documents, 1519, 1577 (August 6, 1997) ("Paragraph (1) of section 1234A (relating to gains and losses from certain terminations) is amended by striking 'personal property (as defined in section 1092(d)(1))' and inserting 'property.' "). That amendment will apply to all terminations occurring more than 30 days after August 5, 1997. After that date, the character of the gain or loss attributable to the cancellation, lapse, or other termination of a forward contract on *any* capital asset will be capital, regardless of whether that asset qualifies as actively traded personal property.

36. The straddle rules contained in § 1092 are discussed below in notes 180-186 and accompanying text.

37. See IRC § 1221.

38. IRC § 865(a). The Service has not exercised its authority under § 865(j)(2) to issue regulations governing the source of income from forward contracts.

39. See IRC § 1001.

40. Section 1234A supplies the missing sale or exchange in the case of certain options. See supra text accompanying note 35.

41. IRC § 865(a)(2).

42. IRC § 871(a)(1) (imposing tax on U.S. source income).

43. IRC § 897(a)(1), (c)(6)(A); Regs. § 1.897-1(d)(2)(ii)(B) ("An option, a contract, or a right of first refusal to acquire any interest in real property . . . will itself constitute an interest in real property other than solely as a creditor.").

C. *Options*

1. *Rights and Obligations.*—An option evidences the right, but not the obligation, to purchase or sell an asset at a specified price (the "strike price"). For every option, there exists (1) a person who has the right (but not the obligation) to require another person to purchase or sell an asset, and (2) a person who is obliged to either purchase or sell an asset upon the request of her counterparty. The person who has the right to purchase an asset from her counterparty, or force her counterparty to purchase an asset, is known as the option holder.[44] The person who is obligated to purchase or sell an asset upon the request of his counterparty is known as the option writer.[45] The holder of an option usually pays money (the "option premium") to the writer in exchange for the option.

An option that accords the holder the right to purchase an asset from her counterparty is known as a "call option." An option that accords the holder the right to sell an asset to her counterparty is known as a "put option."

Parties can use option contracts to guard against, or speculate about, the movement in value of a particular asset. A taxpayer will typically purchase a put option in order to guard against a downward movement in the price of the underlying property. A taxpayer will typically purchase a call option to guard against an upward movement in the price of the underlying property. The following paragraphs will explore the economic characteristics of put and call options.

A person who must sell goods at some point in the future can purchase a put option in order to guard against a downward movement in the sale price of the underlying property.

> *Example.* The forward price of a 9 month forward contract on a bushel of wheat is $10. Jack is not entirely convinced that the price of wheat is going to fall in the next 9 months. Because he is not entirely convinced that the price of wheat will fall, Jack does not want to sell all of his wheat in advance. Jack therefore calls Jill and offers to pay her $2,000 today in return for the right to sell her 1,000 bushels of wheat in 9 months at a price of $12,000. (That is, the option premium is $2 a bushel and the strike price of the put option is $12 a bushel.) Jack thinks that this is a good deal because, if he exercises his rights under the put option, he will receive $12,000 on the sale to Jill and will thus receive a net amount of $10 on the sale of each bushel of wheat ($12,000 sale price for 1,000 bushels of

44. Rev. Rul. 78-182, 1978-2 C.B. 265.

45. 1 Andrea S. Kramer, Financial Products: Taxation, Regulation, and Design 100 (1991).

> wheat minus the $2,000 total option premium). Jill thinks that the option contract is a great deal for her. Jill believes that the price of wheat will increase exponentially. Thus, she believes that Jack will let the put option expire because he will not force her to purchase wheat at a price below its fair market value. If Jack lets the put option expire, Jill gets to keep the option premium.

Jack has only placed at risk the option premium.[46] Jack has insulated himself from a downward movement in the price of wheat. If the spot price of wheat falls below $10 a bushel, Jack will exercise his rights under the put option. Jack will suffer an economic loss if, in 9 months, wheat is trading at a price between $10 and $12 a bushel. In that case, Jack will not want to let the put option expire, because he will forfeit the $2 a bushel option premium and will only receive between $10 and $12 a bushel on the open market. In that case, Jack will receive, net of the forfeited option premium, between $8 and $10 a bushel. If, however, in 9 months, wheat is trading at a price in excess of $12 a bushel, Jack will be able to let the option expire and sell his wheat in the market. For example, if the price of wheat rises to $15 a bushel, Jack will let the option expire and sell his wheat for $15 a bushel; he will receive, net of the forfeited option premium, $13 a bushel ($15 a bushel on the open market minus the $2 a bushel forfeited option premium). In that case, Jack will be able to reap some economic benefit from an increase in the spot price of wheat. From the above discussion, one can see that a put option will enable the holder to eliminate the risk of downward movement in the underlying property while preserving some of the economic benefits of an upward movement in the price of the underlying property.

All of the benefits and risks of a put option do not, however, go to the holder. The writer of a put option keeps the option premium. Thus, Jill stands to gain $2,000 simply by writing a put option. Jill's down side is limited to $10 a bushel. That is because she received an option premium of $2 a bushel, and the strike price of the put option is $12 a bushel. In a worst case scenario, Jack can exercise the put option when the spot price of wheat is $0 a bushel. Thus, net of the option premium, Jill stands to suffer a maximum loss of $10 a bushel, or $10,000.

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46. Henry D. Shereff, Introduction to the Taxation of Financial Instruments 148 (1990) ("The risk on a purchased option is limited to the cost of the premium."). See Rev. Rul. 78-182, 1978-1 C.B. 265 ("The holder of the [call] option is not obligated to purchase the stock that is the subject of the option. Thus, if the market value of such stock were to fall below the price specified in the option contract, the holder normally would not exercise the option and would allow it to lapse."); Shereff, supra, at 148 ("The risk inherent in a purchased put is limited to the premium paid for the put no matter how high the price of the stock rises."). For a review of the economic risks and rewards generated by options, see Francis D. Feeney, A Guide to International Financial Derivatives Part A (1991).

Call options serve the same basic purposes as put options. Call options are, however, the economic opposite of put options. Whereas Jack purchased a put option to guard against a downward movement in the sale price of the underlying property, the purchaser of a call option wants to guard against an upward movement in the price that she will have to pay to purchase the underlying property at some point in the future.

> *Example.* Lilly is a baker. She will have to purchase wheat in 9 months. She believes, but is not entirely convinced, that the price of wheat will increase in the next 9 months. Therefore, she does not want to agree to purchase large quantities of wheat in advance. Lilly goes to Larry, a local wheat farmer, and offers him a $2 a bushel option premium in exchange for the right to purchase wheat in 9 months at a price of $8 a bushel. Larry thinks that this is a good deal for him, because he is convinced that the price of wheat will fall in the next 9 months. Larry believes that Lilly will let the option expire.

Lilly has only placed at risk the option premium. Lilly has eliminated the risk that the price of wheat will increase in the next 9 months. That is because, regardless of the fair market value of wheat in 9 months, Lilly will be able to purchase wheat from Larry at a price of $10 a bushel, including the $2 paid for the option premium. If, however, in 9 months, wheat is trading at a price between $8 and $9 a bushel, Lilly will suffer an economic loss. That is because, if she lets the option expire and purchases wheat in the open market, she will pay between $10 and $11 a bushel, including the amount paid for the expired option. In that case, Lilly will likely exercise her option and purchase wheat for a total price (including option premium) in excess of its fair market value. In contrast, if wheat is trading at a price below $8 a bushel, Lilly will be economically able to let the option expire and purchase wheat in the open market. For example, if the spot price of wheat is $2 a bushel, Lilly can let the call option expire and purchase wheat in the open market. In that case, the total purchase price of wheat would be $4 a bushel, including the premium on the expired option. Thus, a call option insulates the holder from upward movement in the price of the underlying property and also allows the holder to reap some benefits from a downward movement in the price of the underlying property.

Once again, the option writer stands to gain or lose economically. Larry will keep the option premium. If the price of wheat rises beyond $10 a bushel, Larry will suffer an economic loss, because Lilly will, in all likelihood, exercise her option. That means that Larry will be forced to sell wheat at a price below its fair market value.

Taxpayers can enter into option contracts using any asset as the underlying property. It is important to note that, like the parties to a forward contract, the parties to an option contract can settle their obligations in cash.

That means that, if the option writer is the losing party, she must make a payment to her counterparty equal to the difference between the strike price of the option and the fair market value of the underlying property. If the option holder is the losing party, then the option writer simply keeps the option premium.

> *Example.* **Part 1**: Assume that, on the expiration date of the option contract between Lilly and Larry, wheat is trading at a price of $25 a bushel. Lilly and Larry agree to settle the option contract in cash. Larry stands to lose $17, because he is obligated to sell wheat for $8 a bushel when it is worth $25 a bushel. Larry therefore pays Lilly $17. Larry has lost a total of $15 on the contract ($17 payment to Lilly minus $2 option premium received). Lilly has made a total of $15 on the option contract ($17 payment received from Larry minus $2 option premium paid to Larry).
>
> **Part 2**: Assume that, on the forward date, wheat is trading at a price of $2 a bushel. Lilly and Larry settle their obligations in cash. In an option contract, the purchaser only places at risk the option premium. Thus, Lilly lets Larry keep the option premium.

Because taxpayers can enter into cash settled option contracts, it follows that a taxpayer need not own the underlying property in order to write an option contract. It also follows that a taxpayer can purchase or sell an option in order to speculate about the price movement in an asset. Thus, a person could purchase cash-settled call options on wheat instead of purchasing a cash-settled forward contract on wheat.

2. *Timing and Character of Income From Options.*—The parties to an option contract do not recognize gain or loss upon the receipt or payment of the option premium.[47]

In general, the parties to an option contract will only recognize gain or loss by virtue of that contract upon the expiration, cancellation, or transfer of their rights and obligations under that contract.[48] In general, the character

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47. See Virginia Iron Coal & Coke Co. v. Commissioner, 37 B.T.A. 195 (1938), aff'd, 99 F.2d 919 (4th Cir. 1938), cert. denied, 307 U.S. 630 (1939); Rev. Rul. 58-234, 1958-1 C.B. 279, 283 ("It is manifest, from the nature and consequences of 'put' or 'call' option premiums and obligations, that there is no federal income tax incidence on account of either the receipt or the payment of such option premiums, i.e., from the standpoint of either the optionor or the optionee, unless and until the options have been terminated . . . ."). For a comprehensive analysis of the taxation of income from options, see Bruce Kayle, Realization Without Taxation? The Not-So-Clear Reflection of Income From an Option to Acquire Property, 48 Tax L. Rev. 233 (1993).

48. Most options on publicly traded property are settled in cash. Kayle, supra note 47, at 236.

of that gain or loss will be capital, although that character may vary between long term capital and short term capital.[49] If the holder exercises her rights under the option contract, then the parties to that contract will take account of the option premium in determining the amount realized on the sale of the

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49. There are three regimes governing the taxation of options. First, § 1234 addresses the taxation of certain option writers and holders. Second, § 1256 provides rules for the taxation of certain publicly traded and currency options. Third, § 1234A provides rules for the taxation of certain option writers and holders not covered by §§ 1234 and 1256.

Section 1234(b)(1) provides that if the taxpayer writes an option (either a call or a put) on stock, securities, commodities, or commodity futures, she will recognize short term capital gain or loss on any "closing transaction" with respect to that property. The term "closing transaction" means "any termination of the taxpayer's obligation . . . other than through the exercise or lapse of the option." IRC § 1234(b)(2)(A). Thus, if an option writer enters into a cash settlement agreement with respect to an option on one of the properties to which § 1234(b) applies, then this writer will recognize short term capital gain or loss on the transaction.

If a taxpayer writes an option which is classified as a § 1256 contract (a § 1256 option), then the option will be "marked to market" at the end of each taxable year, notwithstanding any other provision of law. That means that that option will be treated as having been sold on the last day of the taxable year, and the option writer will recognize gain or loss accordingly. IRC § 1256(a)(1). In addition, the writer of a § 1256 option will recognize gain or loss upon *any* termination of the writer's obligations under the option. IRC § 1256(c)(1). Any gain or loss recognized by virtue of § 1256 is 40% short term capital, and 60% long term capital. IRC § 1256(a)(3). The parties to a § 1256 option will receive appropriate basis adjustments to the option. IRC § 1256(a)(2). In the most general terms, in order for an option to qualify as a § 1256 option, it must: (1) be publicly traded, and (2) qualify as either (a) a nonequity option (e.g., the value of the option must not be determined by reference to stock or a group of stocks), or (b) a foreign currency contract which is traded on the interbank market and requires delivery of (or settlement in relation to the value of) a foreign currency in which positions are traded through regulated futures contracts. IRC § 1256(b).

Section 1234A will apply to an option writer if: (1) the property subject to the option does not fall under §§ 1234 or 1256; or (2) the property subject to the option does fall under § 1234, but the method of terminating that option does not qualify as a "closing transaction" under § 1234(b)(2). Section 1234A(1) provides that any gain or loss with respect to the "cancellation, lapse, expiration, or other termination of . . . a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset." See supra note 35 regarding recent changes to IRC § 1234A.

The same basic regime that applies to option writers applies to option holders. Section 1234(a) provides that gain or loss attributable to the sale, exchange, or lapse of an option shall be treated as gain or loss from the sale or exchange of property "which has the same character as the property to which the option relates in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him)." Section 1234(a) does not apply to, among other things, options that are, essentially, inventory in the hands of the taxpayer and certain put options where the taxpayer owns the property to which the option relates. Aside from those limitations, the term "property" in § 1234(a) encompasses *all* property. If a taxpayer holds an option to which § 1256 applies, then she must mark the option to market at the end of the taxable year. IRC § 1256(a)(1).

underlying property and the adjusted basis of the underlying property in the hands of the purchaser.[50] In certain instances, items of loss from options may be deferred under section 1092.[51]

3. *Source of Income From Options.*—Options are capital assets in the hands of most investors. The source of income from the sale of personal property is determined by reference to the residence of the owner of that property.[52] Thus, a foreign investor who sells an option, or otherwise terminates her rights or obligations thereunder,[53] will generally recognize foreign source income,[54] on which she will not pay U.S. tax.[55]

III. CONTINGENT DEBT INSTRUMENTS AND EQUITY SWAPS

This article focuses on the proper tax treatment of certain CDIs and equity swaps. Equity swaps are one of the many derivatives that fall under the definition of "notional principal contract." This section of the article will analyze the tax treatment of CDIs and notional principal contracts.

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50. In general, if the writer of a call option is forced to sell the underlying property, then she must add the option premium that she received to the amount realized on the sale of that property (i.e., the strike price) to determine the amount of gain or loss recognized on the sale. Rev. Rul. 78-182, 1978-1 C.B. 265, 267. If the writer of a put option is forced to purchase the asset subject to the put option, then she must subtract the option premium that she received from the basis of the underlying property (i.e., the strike price). Id. at 268-269. If the holder of a call option exercises her right to purchase the underlying property, then she adds the option premium to the adjusted basis of that property. Id. at 266. If the holder of a put option exercises her right to sell the underlying property, then, in computing the amount of gain or loss on the sale of that property, she must subtract the option premium from the amount realized on that sale. Id. at 268.

The above rules do not apply to § 1256 options. Section 1256(c)(1) provides that the exercise of a § 1256 option is a realization event. Therefore, the writer of an exercised option subject to § 1256 must recognize gain or loss as if she sold the option at the time the holder exercised it. The writer of the exercised option computes her amount realized on the sale of the underlying property (or, in the case of an exercised put option, her basis in the underlying property) without regard to the option premium.

51. The straddle rules contained in § 1092 are discussed below in notes 180-186 and accompanying text.

52. IRC § 865(a).

53. Section 1234A supplies the missing sale or exchange element in the case of certain options. See supra text accompanying note 49.

54. IRC § 865(a)(2). The Service has not exercised its authority under § 865(j)(2) to issue regulations governing the source of income from option contracts.

55. IRC § 871(a)(1) (imposing tax on U.S. source income). The exception to that rule relates to long call options, the underlying of which is U.S. real property. In that case, the foreign investor will recognize U.S. source income upon the sale of that option. IRC § 897(a)(1), (c)(6)(A); Regs. § 1.897-1(d)(2)(ii)(B) ("An option, a contract, or a right of first refusal to acquire any interest in real property . . . will itself constitute an interest in real property other than solely as a creditor.").

A. *Contingent Debt Instruments*

1. *Noncontingent Debt Instruments Generally.*—Before reviewing the tax treatment of CDIs, this article will review the tax treatment of conventional (i.e., noncontingent) debt instruments. A noncontingent corporate debt instrument will fall into one of three classes,[56] depending on (1) the way in which interest payments are computed, and (2) the timing of those interest payments.[57] The only type of noncontingent debt instrument relevant to the instant discussion is the zero coupon bond.

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56. Regardless of the class into which a debt instrument falls, all holders of debt instruments ("bondholders") generally share the same rights vis-a-vis the issuer and other bondholders with equal seniority. See infra note 57. Bondholders are creditors of the corporation that issued the bonds. 6A Victoria A. Braucher, Fletcher Cyclopedia on the Law of Private Corporations 5 (Rev. ed. 1997). Generally, bondholders lend money to the corporation in exchange for the corporation's promises to pay interest and return the principal. Id. Bondholders do not have the right to vote on matters that require shareholder approval. Id. Also, bondholders generally do not share in the economic appreciation or depreciation of the corporation. Id. A bondholder's return is generally limited to the interest and principal payments. Id.

57. Bonds that provide for interest payments fall into three basic categories: fixed rate, floating rate, and zero coupon. See generally David C. Garlock, Federal Income Taxation of Debt Instruments (3d ed. 1996). A holder of a fixed rate bond agrees to loan the company a certain sum of money; in return, the company agrees to return the principal and pay the bondholder, on a periodic basis, interest based on a fixed rate. Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 319 (4th ed. 1991). A holder of a floating rate bond also agrees to loan the company money; in return, the company generally agrees to return the principal and pay the bondholder, on a periodic basis, an amount of interest determined by reference to the short term interest rate prevailing at the time of the interest payment. Id.

Holders of fixed and floating rate bonds must report periodic interest payments in income as these holders either receive or accrue those periodic interest payments, depending on their method of accounting. IRC § 451(a). Cash method taxpayers include interest payments in income in the taxable year in which those taxpayers actually or constructively receive those interest payments. Regs. § 1.451-1(a). Accrual method taxpayers include interest payments in income in the taxable year in which all the events occur that fix their right to receive interest payments, and the amount of those payments can be determined with reasonable accuracy. Regs. § 1.451-1(a). Those bondholders recognize ordinary income upon receipt of the interest payments. IRC § 61. If a bondholder sells or exchanges a debt instrument, she is, subject to exceptions not relevant here, entitled to a capital gain or loss.

The source of interest payments is generally determined by reference to the nationality of the borrowing corporation. IRC § 861(a)(1). Interest on corporate bonds received by a nonresident alien individual who is not engaged in a trade or business in the United States is generally exempt from the 30% tax imposed by § 871(a). IRC § 871(h).

Corporations do not recognize income upon the receipt of borrowed funds. E.g., Falkoff v. Commissioner, 62 T.C. 200, 206 (1974). Corporations are generally allowed a deduction with respect to interest. IRC § 163(a). The source of those interest deductions is generally determined through the use of a formula that takes into account all of a taxpayer's assets and liabilities, regardless of where they are situated.

A holder of a zero coupon bond agrees to loan the issuer money in return for *one* payment at maturity.[58] Holders of zero coupon bonds are not entitled to periodic interest payments from the borrowing corporation. Rather, the holder of a zero coupon bond recovers both interest and principal in one payment at maturity.

The difference between the issue price of a zero coupon bond and the amount that the holder is entitled to receive at maturity is called original issue discount ("OID").[59] Holders of zero coupon bonds must, pursuant to sections 1272 through 1275 (the "OID rules"), include in income a portion of that OID for each taxable year between the issuance and maturity of the zero coupon bond.[60] The amounts included in income by virtue of the OID rules are added to the basis of the zero coupon bond.[61] The holder of the zero coupon bond will accrue the entire amount of OID prior to maturity.[62] Thus, at maturity, any money that that holder receives will qualify as a tax-free return of basis.

Interest payments are classified as ordinary income. The source of an interest payment is generally determined by reference to the nationality of the borrowing (payor) corporation.[63] In general, interest payments are, in the hands of a private investor who is a nonresident alien individual, exempt from the 30% withholding tax imposed by sections 871(a)(1) and 1441.[64]

Items of loss from debt instruments are not subject to the loss deferral rules contained in section 1092.[65]

2. *Background on CDIs.*—CDIs can provide for contingent interest and guaranteed principal,[66] contingent principal and guaranteed interest,[67]

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58. 2 Andrea S. Kramer, Financial Products: Taxation, Regulation, and Design 874 (Rev. ed. 1991).

59. IRC § 1273(a)(1).

60. IRC § 1272(a)(1).

61. IRC § 1272(d)(2).

62. The issuer of a zero coupon bond is permitted periodic interest deductions equal to the amount of OID included as interest income by the bondholders. IRC § 163(e).

63. IRC § 861(a)(1).

64. IRC § 871(h).

65. The straddle rules contained in § 1092 are discussed below in notes 180-186 and accompanying text.

66. An example of a CDI that provides for contingent interest and guaranteed principal is the stock-index growth note ("SIGN"). See Alvin C. Warren, Jr., Financial Contract Innovation and Income Tax Policy, 107 Harv. L. Rev. 460, 483 (1993). In a SIGN, an investor lends money to a borrower. In return, the investor will receive, at maturity, (1) the principal and (2) an amount of interest equal to the appreciation in some stock index, such as the Standard and Poor's 500 (the S&P 500). Id. For example, in 1992, Merrill Lynch issued debt securities that had a five-year term and entitled the lender to the return of principal plus 115% of the appreciation, if any, in the S&P 500. Louis S. Freeman & Richard M. Lipton, Tax Consequences of Business and Investment-Driven Uses of Derivatives, 72 Taxes 947, 967 (1994).

or contingent interest and principal. This article will focus primarily on CDIs that (1) are contingent as to both interest and principal and (2) track the value of a capital asset, group of assets, or index.[68]

One variation of the SIGN is the MITTS, which stands for "Standard & Poor's 500 Market Index Target-Term Securities." MITTS, which are a trademarked financial product of Merrill Lynch, are five-year notes that provide for one payment at maturity equal to the issue price of the MITTS or a payment equal to the sum of the issue price of the MITTS plus a payment calculated by reference to the appreciation of the S&P 500. Kenneth Heitner & Jonathan Kushner, To Bifurcate or not to Bifurcate: The Answer Becomes Less Clear, 46 Tax Law. 43, 84 (1992). Another variation of the SIGN is the LYON, or "liquid yield option note." In 1990, Walt Disney Company issued $1.5 billion of LYONs, each of which had an issue price of $411.99 and a yield to maturity of 6%. Holders of a LYON were entitled to receive $1,000 at maturity. Those holders were also entitled to exchange the LYON at any time for an amount of cash equal to the market price of a fixed number of shares of an affiliate of Walt Disney Company. Thus, the LYON issued by Disney was a zero-coupon bond with an embedded call option on the affiliate's stock. Id. at 79. Issuers can, however, issue derivatives such as the LYON that track the value of shares of stock of corporations that are unrelated to the issuer. Freeman & Lipton, supra, at 952 (Salomon, Inc., issued a derivative that tracked the value of the common stock of Digital Equipment Corporation, Inc., a corporation that was unrelated to Salomon).

67. An example of a CDI with guaranteed interest and contingent principal is the A/S Eksportfinas 14.5% Gold-Indexed Notes. Freeman & Lipton, supra note 66, at 958. Those notes provided for periodic interest payments and a payment at maturity calculated by reference to the amount of change in the price of gold between the issue date and the maturity date. Id.

68. This article will not focus on instruments such as contingent installment obligations, which are commonly referred to as "earn-out notes." Under the CDI regulations, earn-out notes are taxed under the rules applicable to nonpublicly traded CDIs that were issued for nonpublicly traded property. Under these rules, all contingent payments are taxed under a "wait and see" approach in which a payment, once made, is characterized as part principal and, based on the applicable federal rate (AFR), part interest. Regs. § 1.1275-4(c)(4). The main problem with that rule is that it encourages the seller of a business to use an earn-out note, rather than a note with a fixed face amount, to finance the sale of her business. That is because the seller/lender in an earn-out note will recognize less ordinary income, and thus more capital gain, than a seller/lender who accepts as payment a noncontingent promissory note.

> *Example.* In transaction one, A sells her business to B. A believes that her business is worth 100x dollars, but B will not pay that amount up front. A's basis in her business assets is zero. B's borrowing rate is 10%. B agrees to pay A 5% of each year's gross receipts for a period of five years. Over five years, B pays A a total of 150x dollars in five yearly payments. Assume that the AFR is 6%. In transaction two, D sells her business to E. D's basis in her business assets is zero. E gives D a five-year promissory note providing for five annual payments equaling 100x dollars, plus 10% interest. Over five years, E pays D a total of 150x dollars.

The sellers in transactions one and two both sell business assets worth 100x dollars and receive therefor a total of 150x dollars over five years. These two transactions will be taxed differently, because A is allowed to compute her interest income using the lower AFR interest rate. That means that she will recognize less ordinary income and more capital gain than D.

For purposes of simplicity, this article will define and discuss one type of CDI that is contingent as to both principal and interest. That CDI will be referred to as a "gold note." This article will use the gold note as a paradigm of the many CDIs that are contingent as to both principal and interest.

NOTE: For purposes of this article, a gold note is defined as a note that (1) has a $1,000 issue price, and (2) provides for one payment in 10 years (the date of maturity) that is equal to the prevailing spot price of 4 ounces of gold. Thus, the lender in a gold note may never receive funds from the borrower. On the other hand, that lender may receive an amount of money that far exceeds the issue price. In reality, a lender and a borrower can construct an instrument such as the gold note using any asset or index as the underlying property. As defined herein, a gold note is economically equivalent to a cash-settled, prepaid forward contract on gold.

Issuers typically[69] develop CDIs such as the gold note for two

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That problem can be remedied by using the borrower's interest rate to determine the amount of each earn-out note payment that is allocable to principal.

David Hariton has suggested a set of rules for determining the yield on instruments such as the gold note, and that approach could be extended to the earn-out note:

> First, interest would accrue currently on the outstanding revised issue price of a contingent debt instrument, at a "reasonable rate." If the debt is issued by a corporation that has outstanding publicly traded noncontingent debt with a remaining life no less than 33 percent shorter, and no more than 50 percent longer, than the term of the contingent debt, then the reasonable rate would equal the yield to maturity of the noncontingent debt on the date the noncontingent debt was issued. Otherwise, the reasonable rate would be determined by a table that, for any given term and established issuer credit rating . . . would set out a percentage of the applicable federal rate of interest (e.g., 125 percent of the applicable federal rate of interest).

David P. Hariton, Contingent Debt: Putting the Pieces Together, 58 Tax Notes 1231, 1242 (Mar. 1, 1993) [hereinafter Hariton, Contingent Debt].

There are, however, some very good reasons to use the AFR in determining the amount of accrued interest on a financial instrument: "As a practical matter, the [AFR] has all the advantages. It is simple, unambiguous, and easy to administer." David P. Hariton, New Rules Bifurcating Contingent Debt-A Mistake?, 51 Tax Notes 235, 239 (Apr. 15, 1991) [hereinafter Hariton, New Rules]. The author, however, believes that, in the context of earn-out notes, the use of the AFR leads to abuses that can be cured only through the use of the borrower's borrowing rate. Other commentators have also complained about the shortcomings of the AFR. See Lawrence Lokken, New Rules Bifurcating Contingent Debt—A Good Start, 51 Tax Notes 495, 503-04 (Apr. 29, 1991).

69. Issuers can also use CDIs such as the gold note to accomplish certain goals which, for regulatory reasons, they would be unable to obtain in the absence of CDIs. See Edward D. Kleinbard, Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System, 69 Tex. L. Rev. 1319 (1991). For example, Times Mirror Co. recently acquired a 2.3% interest in Netscape communications in a private placement. Because of certain provisions of the federal securities laws, Times Mirror was unable to sell that stock for two years. Times Mirror did, however, issue a five-year bond, the repayment of which was

purposes. First, issuers issue gold notes in order to accommodate the needs of *investors*.[70] Second, issuers issue gold notes in order to lower their total financing costs.[71]

Taxpayers will purchase CDIs for the same reasons for which they will purchase long cash-settled forward contracts on the underlying property. In some cases, taxpayers may purchase CDIs because forward contracts with similar terms are not available in the market. For example, assume that (1) a group of investors wishes to purchase 15-year forward contracts on crude oil, and (2) the commodity markets do not offer such contracts. Because XYZ Co. knows that that group of investors exists, it offers a contingent debt instrument having a $1,000 issue price and providing for one payment in 15 years equal to the spot price of 20 barrels of crude oil. Thus, XYZ Co. provides these investors with a financial instrument that they would have otherwise been unable to purchase—a 15-year forward contract on crude oil. In any event, a debt instrument that is fully contingent on the value of the particular underlying property will not vary in either form or economic substance from a long cash-settled, prepaid forward contract on the underlying property.

3. *Taxation of CDIs*

a. *Background.*—Section 1275(d) grants the Service broad discretion to promulgate regulations that address the taxation of CDIs.[72] The

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pegged to the price of Netscape stock. Times Mirror recovered its profit in the Netscape stock when it received the "borrowed" money; the risk of a downward movement, and most of the benefits of upward movement, in the price of Netscape stock was transferred to the purchasers of the bonds. See Sheppard, Adding PEP, supra note 4.

70. Kleinbard, supra note 4, at 954 ("One of the most interesting aspects of the new financial products marketplace is that financial product exotica typically are developed in response to investor demands, not issuer needs."). For example, if there exists a group of investors who wish to purchase 15-year forward contracts on crude oil, and the commodity markets do not provide such contracts, an issuer can construct a CDI that provides for one payment in year 15 equal to the spot price of some quantity of crude oil.

71. Matthew P. Haskins, Can the IRS Maintain the Debt-Equity Distinction in the Face of Structured Notes?, 32 Harv. J. on Legis. 525, 531, 543 (1995) ("A complex structured note may represent an exotic equity-linked market play to the investor while merely being a cheaper source of plain vanilla financing to the issuer."; "Issuers of structured notes expect savings of about twenty basis points when compared with traditional financing."); Heitner & Kushner, supra note 66, at 44 ("In a similar vein, companies, in their never-ending search to lower their cost of borrowing, increasingly are issuing debt securities containing conversion or exchange features. These sweeteners lower the interest rate and provide the investor with an opportunity to participate in the appreciation of the issuer, its affiliates, or the equity markets generally . . . ."); Kelley Holland et al., A Black Hole in the Balance Sheet, Bus. Wk., May 16, 1994, at 81 (analyzing an issuer's ability to reduce financing costs by issuing equity flavored debt instruments).

72. Section 1275(d) states, "[t]he Secretary may prescribe regulations providing that where, by reason of . . . contingent payments . . . the tax treatment under this subpart . . . does

Service wrestled with the problem of developing a tax regime for CDIs for ten years before issuing final regulations in 1996 that govern the taxation of CDIs (the "CDI regulations").[73] Between 1986 and 1996, the Service wrote four sets of proposed regulations addressing the taxation of CDIs,[74] only one of which is relevant here.

In 1991, the Service issued a set of proposed regulations that called for the "bifurcation" of CDIs in certain instances (the "bifurcation regulations").[75] The bifurcation regulations (1) treated certain CDIs as two separate instruments, namely a zero coupon bond and a property right (such as an option or a forward contract);[76] (2) allocated the issue price of those CDIs between the hypothetical zero coupon bond and the property right; and (3) treated the holder of that CDI as having purchased separately that zero coupon bond and that property right.[77] Thus, the holder of a CDI to which the bifurcation regulations applied would recognize a certain amount of OID income on the hypothetical zero coupon bond and a certain amount of capital gain or loss on the hypothetical property right.[78]

b. *The CDI Regulations.*—The CDI regulations[79] provide different rules for (1) publicly traded CDIs that were issued for cash or publicly traded property (e.g., the gold note), and (2) nonpublicly traded CDIs

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not carry out the purposes of this subpart . . . , such treatment shall be modified to the extent appropriate to carry out the purposes of this subpart . . . ."

73. Garlock, supra note 57, at 6-1 to 6-2.

74. Id. For an in-depth analysis of the various sets of proposed CDI regulations, see New York State Bar Association Tax Section & ABA Tax Section, Report and Recommendation for the Treatment of Contingent Debt Instruments Under Proposed Regulation Section 1.1275-4, 61 Tax Notes 1241, 1242-47 (Dec. 6, 1993).

75. Prop. Regs. § 1.1275-4(g), 56 Fed. Reg. 8308 (1991).

76. Prop. Regs. § 1.1275-4(g)(2)-(3), 56 Fed. Reg. 8308 (1991).

77. Prop. Regs. § 1.1275-4(g)(4), 56 Fed. Reg. 8308 (1991).

78. The bifurcation regulations applied to CDIs that met all of the following requirements: (1) the CDI was issued for cash or publicly traded property; (2) the CDI provided for noncontingent payments at least equal to the issue price; and (3) the amount of the contingent payments was determined, in whole or in part, by reference to the value of publicly traded property. Prop. Regs. § 1.1275-4(g)(1), 56 Fed. Reg. 8308 (1991). The bifurcation regulations did not apply to certain instruments, such as CDIs covered by prior sets of proposed regulations, where the CDIs provided for contingent payments that were determined by reference to the value of nonpublicly traded property. In addition, the bifurcation regulations would not have applied to gold notes because these notes do not provide for noncontingent payments at least equal to their issue price.

79. The final regulations are contained in Regs. §§ 1.1272-1, 1.1274-2, 1.1275-2, -4 to -6. For purposes of simplicity, this article will refer to the portions of these regulations that address the taxation of CDIs as "the CDI regulations."

that were issued for nonpublicly traded property. The latter class of CDIs is not relevant to the instant discussion.[80]

With respect to publicly traded CDIs that were issued for cash or publicly traded property, the CDI regulations require the parties to these CDIs to: (1) compute the comparable yield of the CDI by reference to the amount of interest that the issuer would reasonably be expected to pay on a noncontingent fixed rate debt instrument;[81] and (2) accrue *interest income* and expense based on estimates of the amount of the future contingent payments, which estimates, in the end, produce the comparable yield.[82]

The CDI regulations also contain new rules that allow taxpayers to integrate a CDI with certain other positions and treat the integrated position as a single debt instrument for federal tax purposes.[83] That is, if one of the parties to a CDI enters into a "perfect hedge" of the CDI, and the cash flows produced by the combination of the CDI and the perfect hedge replicate the cash flows of a fixed or variable rate debt instrument, then that party will be treated for all purposes of the Code as having issued (or purchased, as the case may be) a fixed or variable rate debt instrument.[84]

In order for a financial instrument to fall within the loss deferral rules of section 1092, the instrument must, among other things, constitute a "position" in property within the meaning of section 1092.[85] Some commentators contend that a CDI qualifies as a position in personal property within the meaning of section 1092.[86] One can, however, argue that under current law, gold notes are not positions in personal property within the meaning of section 1092.[87] There is no clear primary authority supporting either

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80. See sources cited supra note 68.

81. Regs. § 1.1275-4(b)(3)(i), (b)(4)(i)(A).

82. Regs. § 1.1275-4(b)(3)(ii), (b)(4)(ii)(C); see also Daniel Shefter, A Brief Intro to the Contingent Payment Debt Instrument Regs., 72 Tax Notes 479, 479-80 (July 22, 1996) (the CDI regulations employ "a relatively complex approach that generally requires issuers and holders to accrue interest deductions and interest income over time based on a projected payment schedule that is derived from the issuer's cost of capital for fixed-rate noncontingent debt instruments.").

If the actual payments on a CDI, when received by the holders, differ from the estimated payment schedule applicable to that CDI, the issuer and holders of that CDI must adjust their interest deductions and income accordingly.

83. Regs. § 1.1275-6.

84. Id.; see also Edward D. Kleinbard et al., Final Tax Regulations Governing Contingent Payment Debt Obligations, 72 Tax Notes 499, 504 (July 22, 1996) (providing a detailed discussion of the hedging provisions of the final regulations).

85. See infra notes 180-186 and accompanying text.

86. E.g., Sheppard, Adding PEP, supra note 4, at 1594-96.

87. In order for a financial instrument to fall within § 1092, that instrument must constitute a "position" in personal property. Section 1092(d)(2) states that "the term 'position' means an interest (including a futures or forward contract or option) in personal property." The

regulations are not particularly helpful in defining the scope of the term "position," as they simply provide that the term "position" means "position" as that term is used in § 1092(d)(2). E.g., Temp. Regs. § 1.1092(b)-5(h). Section 1092(c)(3)(A)(iii) indicates that debt instruments can be *personal property*, and that a taxpayer who has *positions* in certain debt instruments may be subject to the straddle rules; that provision, however, is not authority for the proposition that a debt instrument itself can qualify as a position in the underlying personal property.

Moreover, § 1092(d)(7) provides that a debt instrument that is denominated in a currency other than the taxpayer's functional currency (a "nonfunctional currency") will be treated as a position in that nonfunctional currency within the meaning of § 1092(d)(2). Section 1092(d)(2) makes clear that a forward contract or option on a nonfunctional currency will qualify as a position in personal property. Thus, one must determine why, if debt instruments already qualify as positions in personal property, Congress enacted a "special rule" for debt instruments denominated in a nonfunctional currency. Perhaps Congress was simply clarifying the law. On the other hand, Congress could have been expressing its belief that debt instruments are not positions in personal property within the meaning of § 1092(d)(2), but that debt instruments denominated in nonfunctional currency were so similar to forward contracts on nonfunctional currency that they should both be treated as positions in personal property. Once again, § 1092 does not clearly indicate whether debt instruments are positions in personal property.

The legislative history to § 1092 does not indicate whether an instrument such as the gold note can qualify as an interest in property. The legislative history does, however, indicate that a convertible debt instrument can qualify as a position in property for purposes of determining whether the stock of the corporation that issued the debt is part of a straddle. Conference Committee Report on P.L. 98-369, at 907-08. That rule may derive, however, from the fact that convertible stock has an *actual* call option embedded in the debt instrument, rather than a right to payments that behave economically like a cash-settled call option. That interpretation would be in keeping with the definition of "position" as an *interest* in property.

The Service has also been less than clear on whether a gold note is a position in property. For example, the Service recently finalized regulations which provide that notional principal contracts are positions in personal property within the meaning of § 1092(d)(2). Regs. § 1.1092(d)-1(c). Given the similarities between gold notes and equity swaps, one must wonder why, if the former already qualifies as a position in property, the latter needs specific regulatory authority in order to so qualify. In light of those regulations, one must also wonder whether the Service believes that debt instruments qualify as positions in personal property. After all, if the Service took the trouble to issue a regulation including notional principal contracts as personal property, why did it not issue a similar regulation for contingent debt instruments? Thus, the § 1092 regulations also illustrate the ambiguities regarding the status of contingent debt instruments under § 1092. In addition, rulings made by the Service do not shed any light on the issue of whether a contingent debt instrument can qualify as a position in personal property. For example, in Rev. Rul. 88-31, the Service ruled that an investment unit consisting of a share of common stock and a contingent payment right was a straddle consisting of that share of common stock and a cash-settled put option. 1988-1 C.B. 302. It is important to note, however, that the Service classified the contingent payment right as a cash-settled put option, which is a position in personal property, rather than as a debt instrument whose value increased as the value of the underlying property decreased. Although that ruling may not provide any guidance as to whether a CDI is a position in personal property, it may be authority for the proposition that a gold note is in fact a cash-settled,

position. Consequently, the proper treatment of gold notes under the loss deferral rules of section 1092 is unsettled.

c. *Problems With the CDI Regulations*

i. *Treating Similarly Situated Taxpayers Differently.*—One of the basic problems inherent in the CDI regulations is that those regulations may allow taxpayers, through the use of CDIs, to manipulate the timing, source, and character of the income resulting from certain investments. For example, although the gold note is identical in both form and substance to a cash-settled, prepaid forward contract on gold, it is potentially subject to a different set of tax rules.[88] In addition, in certain cases, a purchaser of a cash-settled, prepaid forward contract on gold will be subject to the loss deferral rules contained in section 1092, whereas the purchaser of a gold note may not be subject to those rules.[89]

ii. *The Big Questions Go Unanswered.*—As the Service struggled to construct a system for taxing CDIs, it apparently abandoned all hope of answering "the big questions": First, will a particular CDI qualify as debt for federal tax purposes? Second, if a particular CDI is not a debt instrument, then what is it?[90]

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prepaid forward contract on gold. Although that analysis would subject gold notes to the straddle rules, the Service would be unlikely to take that position because, as discussed above, there does not currently exist a coherent set of rules that taxes the interest that accrues on the prepayment amount. After all that, one must return to the same conclusion: There is no *clear* primary authority that indicates whether a CDI can qualify as a position in property within the meaning of § 1092.

88. *Example.* X enters into a cash-settled, prepaid forward contract with Y. Under that contract, X pays Y $1,000 today, and Y agrees to pay, in 10 years, the spot price of 4 ounces of gold. A lends money to B. In return for that loan, B agrees to repay, in 10 years, the spot price of 4 ounces of gold. Assume that the transaction between A and B qualifies as debt under the CDI regulations.

In the above example, X and A have entered into transactions that are virtually identical to one another. The only difference between the two transactions is that one transaction is called a cash-settled, prepaid forward contract, and the other transaction is called a gold note. Yet, X will not recognize income until Y pays her money. The character of that income will be capital, and the source of that income will be determined by reference to X's country of residence. A, on the other hand, will recognize income each year, based on a projected payment schedule that reflects B's cost of capital for fixed-rate noncontingent debt instruments. That income will be ordinary interest income, and the source of that income will be determined by reference to B's nationality

89. See infra notes 180-186 and accompanying text.

90. The CDI regulations: (1) indicate that the rules contained therein only apply to instruments properly classified as "debt" under general principles of tax law; and (2) express no opinion as to which CDIs, *if any*, will qualify as "debt" under those general principles.

One can infer from the Service's ten year struggle to construct a tax regime for CDIs that the Service believes that *some* CDIs are debt instruments.[91] As many commentators have pointed out,[92] there is a dearth of authority pertinent to the classification of CDIs such as the gold note.[93] It

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91. See Shefter, supra note 82, at 486.

92. E.g., David P. Hariton, Distinguishing Between Equity and Debt in the New Financial Environment, 361 PLI/Tax 1015, 1022-1024 (WESTLAW, PLI-TAX) (1994) ("Despite a specific statutory mandate to issue regulations under IRC § 385, there are still no regulations to offer practitioners guidance, and the principal authority for distinguishing between equity and debt is still found under case law. It is no surprise that case law is of limited use in the new financial environment."); Sheppard, Adding PEP, supra note 4, at 1594 ("The Treasury has not addressed the classification of securities that are linked to the shares of an unaffiliated corporation."); Sheppard, Things that Go Bump, supra note 4 (indicating that prominent tax practitioners cannot agree as to the proper classification of certain derivatives akin to the gold note: "[e]xisting government pronouncements about contingent debt—effective and otherwise—are not especially helpful on the classification question."); see also James S. Eustice, 'Debt-Like' Equity & 'Equity-Like' Debt: Treasury's Anti-Hybrid Proposals, 71 Tax Notes 1657, 1657 (June 17, 1996) ("The [debt-equity] issue has been a major engine of Subchapter C turmoil for most of the 20th century, and will probably continue into the 21st so long as corporate equity capital is subjected to double taxation while debt capital is not.").

93. For purposes of this article, CDIs that are contingent as to principal fall into one of two classes. In the first class fall CDIs whose repayment is linked to the value of the issuer's own stock. In the second class fall CDIs whose repayment is linked to the value of a capital asset, such as gold, or an equity interest in a corporation that is unrelated to the issuer of the CDI. The Service has made little, if any, headway in developing an analytical framework that can be used to classify CDIs that fall into the first class. The Service has made absolutely no headway in developing such a framework for CDIs that fall into the second class.

CDIs that provide for payments that vary in accordance with the value of the stock of the issuing corporation are analogous to debt instruments that are convertible into stock of the issuer. In Rev. Rul. 83-98, the Service ruled that adjustable rate convertible notes ("ARCNs") were equity instruments of the issuer of those notes. 1983-2 C.B. 40. The ARCNs were issued at a price of $1,000 cash or a price equal to 50 shares of the issuer's stock (also $1,000). Id. The ARCNs provided for quarterly interest payments at a rate based on dividend payments made on the issuer's common stock. Id. Upon maturity of an ARCN, a holder had a right to receive either (1) $600 cash or (2) 50 shares of the issuer's common stock. Id. The ARCNs were subordinated to all present and future senior and general creditors of the issuing corporation. Id.

The Service noted that: (1) the holders of the ARCNs would most likely exercise their conversion right at maturity because they would only opt to receive the $600 cash payment if the price of the issuer's common stock dropped by more than 40%; and (2) it would be advantageous in many circumstances for the issuer to force conversion of the ARCNs into common stock of the issuer. Id. The Service stated:

> Because of the very high probability that all of the ARCN's issued will be converted into stock, the ARCN's do not in reality represent a promise to pay a sum certain. Rather, the $600 face value is a figure calculated primarily to ensure conversion into stock; its only other function is to provide a floor for purposes of loss that will become material only if the

does, however, appear that CDIs that guarantee the return of principal will be classified as debt for federal tax purposes.[94] An analysis of the proper classification of CDIs by analogy to equity swaps would be pointless because,

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> price of [the issuer's] . . . common stock declines by more than 40 percent from its price at the time the ARCN's are issued.

Id. at 41.

In Rev. Rul. 85-119, a domestic bank holding company ("HC") issued certain notes (the "HC notes") for cash. 1985-2 C.B. 60. The HC notes had a 12-year maturity, provided for quarterly interest payments, and did not accord holders the right to vote or participate in the management of HC. Id. Upon maturity or redemption of the HC notes, the holders thereof were entitled to receive either: (1) an amount of cash equal to the principal amount of the notes; or (2) a number of shares of HC stock, the aggregate fair market value of which was equal to the principal amount of the notes. Id.

The Service held that the HC notes were debt for federal tax purposes. Id. at 61. The key facts relied upon by the Service were (1) that the holders of the HC notes were entitled to receive cash at maturity of those notes and (2) that HC and the holders of the HC notes intended "to create a debtor-creditor relationship." Id. The Service did, however, limit Rev. Rul. 85-119 to its facts. Id.

In Notice 94-47, the Service stated that it would "scrutinize" instruments that are designed to be treated as debt for federal tax purposes and as equity for regulatory, rating agency, or financial accounting purposes. 1994-1 C.B. 357. The Service again set forth a laundry list of factors relevant to the debt/equity analysis. Id.

Notice 94-47 does not include in the list of debt/equity factors the issue of whether payment of the instrument is linked to the *value of the issuer's stock*. Id. The fact that Notice 94-47 does not analyze the effect of payments that vary in accordance with the stock of the issuer is troubling, to say the least, because that factor "is arguably the most important factor in distinguishing between equity and debt." Hariton, supra note 92, at 1064 ("[A]ll debt-equity characterization can be described as an effort to determine whether (at least in relation to someone else) an investor is participating in the issuer's profits and risks."). Thus, it is unclear whether a CDI that provides for contingent payments linked to the value of an issuer's stock is debt. From the above rulings, in conjunction with Rev. Rul. 88-31, discussed at supra note 87, one could reasonably conclude that a CDI that is wholly contingent on the value of the issuer's stock is a cash-settled forward contract on that stock and that such a CDI is akin to ownership in that stock. 1988-1 C.B. 302. The correct answer does, however, remain unclear.

There is virtually no authority for the proposition that CDIs whose repayment is linked to the value of a capital asset other than the issuer's stock are anything other than debt instruments. There is likewise no authority for the proposition that such CDIs *are* debt. Thus, it appears that the proper classification of CDIs whose repayment is linked to the value of a capital asset is, to coin a phrase, "up in the air."

94. Some CDIs provide for (1) a guaranteed return of principal and (2) interest payments that are contingent on the value of some asset or index. These CDIs are economically equivalent to a zero-coupon bond stapled to a cash-settled call option on the underlying property. The Service and the courts, however, have not been prone to bifurcating debt instruments into zero-coupon bonds and call options. See Freeman & Lipton, supra note 66, at 954-55 (discussing two cases in which the courts bifurcated a financial instrument into debt and equity components; the authors note that there are "few exceptions" to the rule that an instrument is *either* debt or equity). Thus, it appears that, so long as a debt instrument guarantees the return of principal, courts will most likely characterize that instrument as debt.

as will be discussed below, the classification of equity swaps is as uncertain as the classification of CDIs.[95] Rather than pondering the classification of CDIs under current law, this article, in Part IV, will provide the author's views on the appropriate classification of certain CDIs.

B. *Notional Principal Contracts*

1. *Introduction.*—A notional principal contract ("NPC") is a financial instrument that obligates each party to make periodic payments that are computed with reference to the value of a specified index on a "notional" sum of money (the "notional principal amount").[96] The notional principal amount is, for purposes of this article, never exchanged.[97]

Some common examples of NPCs are interest rate swaps, caps, floors,[98] commodity swaps,[99] and equity swaps.[100] The only NPCs rele-

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95. Compare Kleinbard, supra note 69, at 1338-39 (indicating that equity swap payments may give rise to capital gain or loss) with David P. Hariton, Equity Swaps, New Regulations, and Ed Kleinbard's Article, 52 Tax Notes 1221, 1222 (Sept. 2, 1991) (expressing skepticism as to Mr. Kleinbard's views on the proper character of income from equity swaps).

Regulations section 1.446-3 provides no help on the classification issue. This regulation merely states that an instrument will not qualify as a notional principal contract if the instrument qualifies as debt under federal tax law. Regs. § 1.446-3.

Some commentators suggest that, under current case law, equity swaps are not "equity" interests because the purchaser of equity in an equity swap does not obtain an ownership interest in the underlying property. Kevin Dolan & Carolyn DuPuy, Equity Derivatives: Principles and Practice, 15 Va. Tax Rev. 161, 178-79 (1995).

96. Regs. § 1.446-3(c)(1) (an NPC 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.").

97. The parties to a currency swap do exchange the underlying currencies at the end of the swap agreement. John Hull, Options, Futures, and Other Derivative Securities 125 (2d ed. 1993). Currency swaps, however, are beyond the scope of this article.

98. Interest rate swaps are economically equivalent to a series of cash settled forward contracts. Warren, supra note 66, at 487. In a fixed for floating interest rate swap, a company may agree to pay a bank 8% multiplied by a notional principal amount of $1,000 for five years, while the bank in turn agrees to pay the company LIBOR multiplied by a notional principal amount of $1,000 for five years. See Smith et al., supra note 21, at 205.

Caps and floors are economically equivalent to a series of cash-settled options. See Warren, supra note 66, at 488 ("Just as [a] . . . swap . . . can be disaggregated into a series of cash settlement forward contracts, [a cap] . . . can be disaggregated into a series of cash settlement options."). Taxpayers can use caps and floors to guard against significant movement in interest rates. See Warren, supra note 66, at 487-88. For example, assume a company borrows $1,000 for ten years at LIBOR when LIBOR was at 6%. The company decides to protect itself against a dramatic upward move in the LIBOR. Therefore, the company pays a bank a set amount of money in return for the bank's promise to pay the excess, if any, of LIBOR over 10%. A floor is simply the flip-side of a cap. Thus, in a floor, the company, in

vant to the instant discussion are commodity swaps and long equity swaps.[101] Commodity swaps and equity swaps are economically equivalent to a series of cash-settled forward contracts.[102]

In a commodity swap, one party (the "first party") agrees to pay a fixed sum of money on each payment date.[103] The counterparty agrees to make periodic payments equal to the spot price of a given commodity on each payment date.[104] Thus, the first party is in the same economic position in which she would have been had she entered into a series of long cash-settled forward contracts, each having a different forward date.[105] Taxpayers

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exchange for a payment or series of payments from the bank, would agree to pay the bank the excess, if any, of 6% over LIBOR. Caps and floors are economically equivalent to options because the "writer" of a cap exposes itself to a downside in return for a premium, and the "holder" of a cap or floor pays a premium in exchange for a potential upside. In the floor discussed above, the company has sold its upside in LIBOR in return for a premium from the bank. That is, the company's upside is limited to the amount it received for the floor, and the company can no longer benefit from downward movement in its interest rate. A company that purchases a cap has a downside limited to the "premium" used to purchase that cap, but has a potentially unlimited upside because there is theoretically no limit on the extent to which interest rates can rise.

99. 1 Kramer, supra note 45, at 139.

100. Regs. § 1.446-3(c)(1)(i); see also 2 Kramer, supra note 58, at 1421.

101. Hereafter, all references to swaps will be limited to commodity and equity swaps.

102. Smith et al., supra note 21, at 48-49. Swaps are akin to a string of cash-settled forward contracts because the parties to a swap make periodic payments to one another to reflect any changes in the value of the underlying property. In essence, swaps are forward contracts that are marked-to-market and then reestablished on a periodic basis. See Id. In this sense, a swap is analogous to a futures contract on the underlying property. Id. Because of the periodic payments, equity swaps expose the parties to less credit risk than forward contracts. Id.

103. 1 Kramer, supra note 45, at 139.

104. 1 Kramer, supra note 45, at 139. A commodity swap is similar to an interest rate swap, in that one party must make variable payments and another party must make fixed payments. In the commodity swap, however, the underlying property is a commodity.

105. 1 See Kramer, supra note 45, at 139. Kramer provides the following example of a commodity swap:

> For example, an airline that buys its oil on the spot market makes an agreement with a bank to fix its oil costs over five years. The airline agrees that every six months it will owe the bank $20 million, representing the price of one million barrels of oil at $20 each. At the same time, the bank agrees that every six months it will owe the airline the price of one million barrels of oil in the spot market. If the spot price is above $20 a barrel, the bank pays the airline the difference. If the spot price is lower, the airline pays the bank the difference.

typically purchase commodity swaps to reduce the risk of price movements in a particular commodity that the taxpayer produces or must purchase.[106]

In a long equity swap, the purchaser makes periodic payments equal to the sum of (1) the decline in value of a particular share of stock or group of stocks, and (2) a certain amount of interest. In return, that taxpayer receives periodic payments equal to the sum of (1) the dividends paid on that stock or group of stocks, and (2) the economic appreciation in that stock or group of stocks.[107]

One can think of an equity swap as a series of cash-settled forward contracts. That is because, like the parties to a cash-settled forward contract, the parties to an equity swap must make payments to one another to take account of the movement in the value of the underlying property. Because these payments are made periodically, these parties are in the same position in which they would have been had they (1) entered into a forward contract, (2) settled that contract in cash after a short period of time, (3) reopened a new cash-settled forward contract with identical financial terms, and (4) repeated steps (1) through (3) over and over again. Hence, equity swaps are akin to a series of cash-settled forward contracts.

Some investors find equity swaps to be more advantageous than cash-settled forward contracts for a simple reason: The parties to an equity swap must make periodic payments to one another to take account of price changes in the underlying property. This means that the parties to an equity swap assume less credit risk than do the parties to a cash-settled forward contract. Put differently, the parties to an equity swap do not have to sit around for a number of years wondering whether their respective counterparties will actually make the payments required under the agreement. An equity swap will, however, produce the same economic returns as a cash-settled forward contract. That is because, by the end of the equity swap agreement, the net amount of the payments made by each party to the equity swap will equal the net amount of the payments that these parties would have made had they entered into a cash-settled forward contract that had the same underlying property and quantity terms as the equity swap in question.

Taxpayers enter into equity swaps for the same economic reasons that taxpayers enter into cash settled forward contracts. Some taxpayers may be attracted to equity swaps because of the diminished credit risk. Also, some taxpayers enter into equity swaps rather than forward contracts because they

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106. 1 Kramer, supra note 45, at 139.

107. Erika W. Nijenhuis, Taxation of Notional Principal Contracts, in Reuven S. Avi-Yonah et al., Taxation of Financial Instruments § 3:41, at 3-83 (1996) [hereinafter Avi-Yonah et al.]. Equity swaps can also contain terms different than those referenced in the text. Id.

are unable to either sell, purchase, or enter into a forward contract with respect to, the underlying property.[108]

> *Example.* Pension Fund owns 8% of X Co. stock. Pension Fund thinks that X Co. stock will decrease in value in approximately one year. Pension Fund has found it impossible to sell all of its interest in X Co. without adversely affecting the price of X Co. stock. Insurance Co. believes that X Co. stock will increase in value in the next year. For regulatory reasons, Insurance Co. cannot purchase stock in X Co. Therefore, Pension Fund and Insurance Co. enter into an agreement with the following terms: Every six months, Pension Fund will pay Insurance Co. an amount of money equal to the dividends paid on X Co. stock and any appreciation of X Co. stock that occurred between the payments. Insurance Co. will pay Pension Fund an amount of money equal to the depreciation in X Co. stock and an amount of interest.

In the above example, Pension Fund will lose money if X Co. stock increases in value. In that case, Pension Fund will have to pay Insurance Co. an amount of money equal to that appreciation. If X Co. stock decreases in value, Pension Fund will make money because Insurance Co. will have to pay Pension Fund an amount of money equal to that depreciation. Economically, Pension Fund is in the same position in which it would have been had it entered into a short cash-settled forward contract on the X Co. stock.

Insurance Co. will make money if X Co. stock increases in value. In that case, Insurance Co. will receive a payment from Pension Fund. If X Co. stock decreases in value, Insurance Co. will have to make a payment to Pension Fund, and will therefore lose money. Thus, Insurance Co. is in the same economic position in which it would have been had it purchased a long cash settled forward contract on X Co. stock.

Investors can enter into an equity swap using any asset as the underlying property, and that asset need not be publicly traded.[109] Given the similarities between long equity swaps and commodity swaps, it is sufficient

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108. Kleinbard, supra note 69, at 1330-31. Institutional investors, some of whom find it difficult to liquidate their equity holdings profitably, often sell equity swaps in order to "improve equity returns or change their bets on the stock market's direction." Lee A. Sheppard et al., Panels Hone in on Financial Instruments, Corporate Issues, 54 Tax Notes 1314, 1314 (Mar. 16, 1992).

109. For example, a taxpayer can enter into a long equity swap that: (1) entitles her to receive the appreciation of, and rent from, a storage warehouse; and (2) obligates her to make payments equal to the sum of (a) an interest rate and (b) the decline in value of that storage warehouse.

for purposes of this article to treat commodity swaps as a subset of long equity swaps.[110]

2. *Taxation of NPC Income*

a. *Timing.*—The timing of income from NPCs is governed by Regulations section 1.446-3. When a taxpayer purchases a swap, she generally has the option of making payments at intervals of one year or less over the term of the swap agreement ("periodic payments") or making one lump-sum payment either at the inception of the swap agreement or at some point during the period in which the swap agreement remains open ("nonperiodic payment"). That is, the purchaser of an equity swap or commodity swap, like the purchaser of a cash-settled forward contract, can prepay the purchase price of the contract.[111]

Regulations section 1.446-3 treats periodic and nonperiodic payments differently. Regulations section 1.446-3(e)(2)(i) states: "All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates."[112]

Subsections (f) and (g) of Regulations section 1.446-3 provide rules for the taxation of swaps where the purchaser makes one nonperiodic payment at the inception of the swap agreement (a "prepayment"). If that prepayment is "significant," the following rule applies: The parties must treat the swap

> as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The

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110. As discussed above, commodity swaps resemble a series of cash-settled forward contracts. Commodity swaps differ from equity swaps in form only. The relevant question in both cases remains the same: Should the purchaser of the swap, by virtue of the form of the transaction and the economic benefits and risks of the transaction, be treated as having an ownership interest in the underlying? Therefore, it is appropriate, for purposes of simplicity, to treat commodity swaps as a subset of equity swaps.

111. Presumably, the prepayment price of the equity swap or commodity swap will be less than the total amount of periodic payments that the investor would be required to pay over the life of the swap. If that were not the case, an investor would have no incentive to pay for the swap in advance.

112. Regs. § 1.446-3(e)(2)(i). Thus, the NPC regulations place cash method taxpayers on the accrual method with respect to items of income and deduction arising from NPCs. For example, assume a cash method, calendar year, taxpayer is entitled to receive an NPC payment on February 15, 1998, and that payment covers the period between November 1, 1997, and January 31, 1998. Under Regs. § 1.446-3, that cash method taxpayer must include in her 1997 taxable income the portion of the February 1998 payment that relates to the 1997 months.

> time value component associated with the loan is *not included in the net income or net deduction from the swap . . . but is recognized as interest for all purposes of the Internal Revenue Code.*[113]

Regulations section 1.446-3 does not provide a definition of the term "significant."[114] For purposes of this article, however, it is sufficient to note that a complete prepayment of a swap constitutes a significant nonperiodic payment within the meaning of the regulations. Thus, the tax law currently recognizes and takes account of the time value component of a prepayment on an equity swap, but does not recognize or take account of the time value component of a prepayment on a forward contract.

Regulations section 1.446-3 also provides some fairly complicated rules governing the tax treatment of payments that terminate an NPC. For purposes of this article, it suffices to say that taxpayers can terminate their obligations under an NPC without subjecting themselves to these rules.

Items of loss from equity swaps may, in certain instances, be deferred under section 1092.[115]

b. *Character.*—There are no set rules governing the character of NPC income.[116] In certain cases, gains or losses resulting from the termination of an NPC will be classified as capital pursuant to section 1234A.[117] Section 1234A, however, does not explicitly apply to *periodic* payments. Thus, the character of those payments is still an open question.

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113. Regs. § 1.446-3(g)(4) (emphasis added). If that prepayment is not "significant," then the parties must, in general, (1) recognize items of income or deduction with respect to that prepayment over the life of the swap and (2) assign those items of income or deduction to the taxable years to which they relate. Regs. § 1.446-3(f)(2)(i).

114. The examples contained in Regs. § 1.446-3 indicate that a prepayment equal to 10% of the present value of all payments due under the contract is not significant, whereas a prepayment equal to 40% of the present value of all payments due under a contract is significant. The regulations, however, do not indicate where the "line" is between a 10% prepayment and a 40% prepayment. Compare examples 2 and 3 of Regs. § 1.446-3(g)(6).

115. The straddle rules contained in § 1092 are discussed below in the text accompanying notes 180-186; see also David P. Hariton, The Tax Treatment of Hedged Positions in Stock: What Hath Technical Analysis Wrought?, 50 Tax L. Rev. 803, 812-13 (1995).

116. Mary L. Harmon & Daniel P. Breen, The Changing World of Equity Derivatives, 378 PLI/Tax 475, 482 (WESTLAW, PLI-TAX) (1995) ("Significant uncertainties with regard to the character of equity swap payments continue to exist."); see also Hariton, supra note 115, at 809-11.

117. See IRC § 1234A(1). NPCs qualify as "personal property" within the meaning of § 1092 if "contracts based on the same or substantially similar specified indices are purchased, sold, or entered into on an established financial market." Regs. § 1.1092(d)-1(c)(1).

Some commentators argue that, because periodic payments do not result from a sale or exchange, the character of those payments must be ordinary.[118] Other commentators state that such payments may give rise to capital gain or loss.[119] Many commentators, however, simply acknowledge that the question remains open.[120]

c. *Source.*—Section 1.863-7(b) provides the general rule that NPC income is sourced to the residence of the recipient.[121] Thus, although gold notes and equity swaps may be identical to one another in economic substance, the income from these two derivatives are subject to different sourcing rules.

The sourcing rule applicable to equity swaps may give rise to inappropriate results in certain situations.[122] For example, assume that a foreign investor enters into a long equity swap on GM stock. That swap entitles the foreign investor to the appreciation and dividends on GM stock. If that investor had purchased GM stock, these dividend payments would be subject to U.S. withholding tax. However, because the regulations provide that swap payments are sourced to the residence of the payee, the foreign investor will not be subject to U.S. tax when he receives a swap payment equal to the amount of dividends declared on GM stock.[123] The preamble to Regulations section 1.446-3 indicates that the Service is aware of this potential abuse and is considering altering the sourcing rules applicable to certain NPCs.[124]

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118. Harmon & Breen, supra note 116, at 482.

119. Kleinbard, supra note 69, at 1341-44.

120. See Harmon & Breen, supra note 116, at 482.

121. Regs. § 1.863-7(b); see also 2 Kramer, supra note 58, at 1466.

122. See May, supra note 25, at 1228 (analyzing the way in which foreign investors can manipulate the sourcing rules of Regs. § 1.863-7(b) to avoid withholding taxes).

123. See Regs. § 1.863-7(b).

124. T.D. 8491, 1993-2 C.B. 215. The Preamble states:

> [T]he final [section 1.446-3] regulations provide that a specified index may be almost any fixed rate or variable rate, price, or amount based on current, objectively determinable financial or economic information. In light of the broad definition of specified index, the IRS is considering whether notional principal contracts involving certain specified indices (*e.g.*, one issuer's stock) should be excluded from the general sourcing rules of sections 861 through 865 . . . .

Id.; see also Hariton, supra note 95, at 1222-23 ("The . . . conclusion that income from an equity-index swap qualifies for sourcing under the residence rule raises some troubling questions, however. The withholding tax on U.S.-source dividends . . . can be avoided through the issuance, by foreign financial institutions, of 'surrogate stock' of U.S. corporations."); May, supra note 25, at 1225 (indicating that foreign investors can avoid U.S. withholding taxes by entering into equity swaps).

Another discrepancy in the NPC sourcing rules concerns long equity swaps into U.S. real property. The disposition of long forward contracts on U.S. real property gives rise to U.S. source income, because a forward contract qualifies as a U.S. real property interest.[125] A long equity swap into U.S. real property may not qualify as a U.S. real property interest, because the purchaser of that equity swap does not acquire a direct ownership interest in that land. The Service can argue that a long equity swap is an interest in U.S. real property because a long equity swap constitutes a "direct or indirect right to *share* in the appreciation in the value, or in the gross or net proceeds or profits generated by [the underlying real property]," which right is classified by the regulations as an ownership interest in U.S. real property.[126] That argument will likely fail, however, because the purchaser of a long equity swap does not *actually share* in the appreciation in, or in the proceeds generated by, the underlying real property. Put differently, the owner of U.S. real property can sell a thousand different equity swaps, each of which entitles the counterparty to the rent and appreciation of that U.S. real property. It would be quite difficult for the Service to contend that all 1,000 counterparties *share* in the rent and appreciation when each counterparty has a right to 100% of these items.[127] Thus, it appears that income from long equity swaps into U.S. real property will be sourced to the residence of the payee. The Service acknowledges that this result is problematic,[128] but has yet to address the problem through regulations.

IV. ECONOMIC EQUIVALENCIES

Derivatives are financial instruments that increase or decrease in value in relation to the movement in value of the underlying property. The value of the underlying property can move in only two directions—up or down. Because there are more than two types of derivatives, one must conclude that certain derivatives are economically equivalent to one another.[129] One must

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125. See supra notes 38-43 and accompanying text.

126. Regs. § 1.897-1(d)(2)(i) (emphasis added).

127. One could make the same argument with respect to a cash-settled forward contract on the underlying real property. The fact remains, however, that all forward contracts pertaining to real property are interests in real property within the meaning of § 897, whereas equity swaps into U.S. real property must, in order to qualify as an interest in real property, satisfy all of the requirements contained in the regulations promulgated under § 897.

128. See T.D. 8491, 1993-2 C.B. 215 (stating that the Service is considering whether § 897 applies to equity swaps into U.S. real property).

129. Smith et al., supra note 21, at 58. Smith notes:

> Forwards, futures, swaps, and options—to the novice, they look very different from one another. . . . However, it turns out that forwards, futures, swaps, and options are not really unique constructions but

also conclude that, to the extent that derivatives can track the value of the underlying property, some derivatives must be economically equivalent to ownership interests in the underlying property.[130] This section of the article analyzes some of the basic economic equivalencies relevant to the instant discussion.[131]

A. *Ownership, Forwards, Gold Notes, and Equity Swaps*

A long forward contract on the underlying property (i.e., a contract to purchase the underlying property) is the economic equivalent of a direct ownership interest in that property.[132]

The above discussion establishes that a gold note is economically equivalent to a cash-settled, prepaid forward contract. That discussion also indicates that long equity swaps are economically equivalent to a series of long cash-settled forward contracts on the underlying property.[133] If gold notes and equity swaps are economically equivalent to long forward contracts, and long forward contracts are economically equivalent to direct ownership interests in the underlying property, then gold notes and long equity swaps

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> resemble those plastic building blocks that children snap together into complex creations. . . . As we have seen: (1) Futures are built by "snapping together" a package of forwards. (2) Swaps are similarly built by "snapping together" a package of forwards. (3) Options can be built by "snapping together" a forward and a riskless security. (4) Options can be "snapped together" to yield forward contracts; conversely, forwards can be "unsnapped" to yield a package of options.

Id.

130. See Mark Fichtenbaum, The Forms of Equity Investments Produce Disparate Tax Effects, 14 J. Tax'n Inv. 12, 12 (1996) ("Over the years, many financial products have been introduced that allow investors to use alternative means to achieve similar economic results. The most basic method of investing—purchasing equity in a publicly traded company—can be accomplished in at least four different ways.").

131. This article will only discuss the two most basic financial equivalencies that are relevant to the instant discussion. The remaining financial equivalencies are beyond the scope of this article. For a discussion of certain financial equivalencies, see Randall K.C. Kau, Carving Up Assets and Liabilities—Integration or Bifurcation of Financial Products, 68 Taxes 1003, 1004-05 (Dec. 1990) (listing 13 transactions which replicate the cash flows of fixed-rate debt).

132. See Smith et al., supra note 21, at 47 n.4.

133. Smith et al., supra note 21, at 48-49 ("[A] swap contract is in essence nothing more complicated than a series of forward contracts strung together."). The only difference between a cash-settled forward contract and an equity swap is that the parties to an equity swap choose to eliminate some of the credit risk attendant to a cash-settled forward contract through the use of periodic payments. For purposes of this discussion, it suffices to say that an equity swap is the economic equivalent of a cash-settled forward contract.

must also be economically equivalent to direct ownership interests in the underlying property.

Although forward contracts, gold notes, equity swaps, and ownership interests in the underlying property are economically equivalent positions, they are taxed differently. Given the ease with which an investor can acquire any of the above four positions, an investor can enjoy the economic benefits of ownership of the underlying property and also remain free to choose the timing, source, and character of the income (or deductions) from her investment.

B. *Put-Call Parity*

The final economic equivalency relevant to our discussion is "put-call parity."[134] Put-call parity is best explained through examples, such as the following:

> *Example.* Assume that Z Co. does not pay dividends on its stock, and that, on day 1, Z Co. stock is currently trading at $100 a share. Further assume that, on day 1, an investor can purchase a call option on Z Co. stock at a strike price of $100, and sell a put option on Z Co. stock at a strike price of $100. Also assume that an investor can purchase a one-year, $100 zero coupon bond for $90.[135]

If an investor, on day 1, purchases both the zero-coupon bond and the call option, and sells the put option, she will be, at the maturity date of the zero coupon bond, in the same economic position in which she would have been had she purchased one share of Z Co. stock for $100 on day 1. That is because, on the maturity date of the zero-coupon bond, the investor will receive $100. If Z Co. is trading at more than $100, the investor will exercise her call option and obtain the stock for $100. If Z Co. is trading at less than $100, the party to whom she sold the put option will exercise that put and force the investor to pay $100 for stock that is worth less than $100. Thus, in each case, the investor will pay $100 (including the net option premium) and will be subject to the economic risks and benefits of ownership of Z Co. stock. That is why the combination of a zero coupon bond, a long call option, and a short put option, is referred to as "synthetic stock." That combination, however, can also be used to create synthetic ownership positions in any asset.[136]

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134. See Warren, supra note 66, at 465-66.

135. See Warren, supra note 66, at 466. This example was adapted (i.e., simplified) from an example contained in Alvin C. Warren's article.

136. See Smith et al., supra note 21, at 55-56.

If an investor only wishes to enjoy the economic risks and benefits of ownership of Z Co. stock without actually purchasing the zero coupon bond (which funds the stock purchases pursuant to the options), an investor can simply purchase a call option with a strike price of $x and, at the same time, sell a put option with a strike price of $x on Z Co. stock. That option combination (an "option pair") at all times will expose the investor to the same economic risks and benefits attendant to ownership of Z Co. stock.[137] Again, an investor can enter into an option pair using any asset as the underlying property.

Although synthetic stock and an option pair generate the same economic returns as an ownership interest in the underlying property, these positions are taxed differently than an ownership interest in the underlying property. In fact, synthetic stock and the option pair are themselves taxed differently. That is because the holder of a zero coupon bond must periodically accrue ordinary interest income.[138]

C. *Economic Equivalencies and Tax Discrepancies*

The economic equivalencies and tax discrepancies discussed above can be summarized in the following table:

137. See Smith et al., supra note 21, at 56 ("Consider a portfolio constructed by buying a call and selling a put with the same exercise price. . . . [T]he resulting portfolio . . . has a payoff profile equivalent to that of buying a forward contract on the asset.").

138. This point is relevant only for an investor who does not have enough money to purchase a zero coupon bond at the time she purchases the option pair. If she does have enough money to purchase that zero coupon bond, however, she will likely be taxed in the same way that she would have been taxed had she purchased a share of synthetic stock. This is because the investor will presumably do something with her money that will generate taxable income.

Financial Instrument	Timing	Character	Source
Underlying property (e.g., stock or real estate)	Income from sale taxed upon sale or exchange. *May be subject to section 1092.*	Capital.	Income from sale determined by reference to owner's nationality. Exception for interests in U.S. real property.
Prepaid Forward Contract	Income from sale or termination taxed upon sale or termination. Prepayment not treated as a loan. *May be subject to section 1092.*	Capital.	Determined by reference to owner's nationality. Exception for forward contracts on U.S. real estate.
Gold Note	Interest accrued over life of the note. *May not be subject to section 1092.*	Ordinary.	Determined by reference to borrower's nationality. Generally exempt from withholding under section 871(h)(4)(C)(v). Effect is to treat as foreign source income in the hands of a foreign investor.
Prepaid Equity Swap	Prepayment treated as loan. Periodic payments accrued over life of swap. *May be subject to section 1092.*	Character of loan payments is ordinary. Character of periodic payments unsettled. Character of termination payments is capital.	Determined by reference to owner's nationality. *No exception to sourcing rule if underlying is U.S. real estate.*
Synthetic Stock	Income accrued over life of zero coupon bond. Income from options recognized upon sale or termination of the options, unless exercised. Exception for section 1256 option. *May be subject to section 1092.*	Part ordinary and part capital.	Determined in part by reference to borrower's nationality and in part by reference to owner's nationality. Exception to nationality rule for options on U.S. real estate.

Option Pair	Income from sale or termination taxed upon sale or termination, unless exercised. Exception for options subject to section 1256. *May be subject to section 1092.*	Capital.	Determined by reference to owner's nationality. Exception for options on U.S. real estate.

With these financial equivalencies and tax discrepancies in mind, this article now turns to the recommendations for prepaid forward contracts, contingent debt instruments, and equity swaps.

V. RECOMMENDATIONS

The root cause of much of the debate surrounding the proper tax treatment of CDIs and equity swaps is the absence of a coherent tax regime applicable to cash-settled, prepaid forward contracts.[139]

As the above discussion indicates, there is no difference, in either form or economic substance, between a cash settled, prepaid forward contract and a gold note. Also, there is no difference, in either form or economic substance, between a series of cash settled, prepaid forward contracts and a prepaid equity swap. Given these equivalencies, one would assume that the decisionmakers in the Service would want to classify and tax gold notes and prepaid equity swaps as cash settled, prepaid forward contracts. These decisionmakers, however, cannot do that because current law does not provide a coherent method for taxing prepaid forward contracts.

The above discussion indicates that many of the tax policy problems presented by financial derivatives can only be solved through a comprehensive overhaul of our current tax system.[140] Specifically, many of those tax

139. See ABA Section of Taxation Committee on Financial Transactions, Tax-Exempt Financing, and Foreign Activities of U.S. Taxpayers, Report on Proposed Regulations Regarding Debt Instruments with Contingent Payments, 49 Tax Law. 195, 202 (1995) [hereinafter ABA Report] ("[T]he taxation of [certain] financial products in some cases is presently unknown and, in other cases, is well-established but inconsistent with the [principles behind the OID rules]. Prepaid forward contracts fall into the former category, while options fall into the latter."); Weisbach, supra note 26, at 498 (indicating that there is no set of tax rules specifically applicable to prepaid forward contracts).

140. E.g., Haskins, supra note 71, at 526, 543-44 (suggesting that equity-flavored debt instruments strain the Service's ability to maintain the distinction between debt and equity); Lokken, supra note 68, at 500 ("Economically, there is no difference between interest accruing on a bond and the change in value of a share of stock, except that the former is quite certain and the latter is highly uncertain. This difference disappears once a contingency is

policy problems are the result of the discontinuities in tax treatment resulting from the debt/equity and capital gain/ordinary income distinctions. Until these distinctions are eliminated, we will never completely end the current practice of treating economically equivalent financial instruments differently. For example, until these distinctions are eliminated, a share of stock in X Co. will always be treated differently than a share of synthetic stock having X Co. as the underlying property.

We cannot, however, escape the fact that Congress is not likely to eliminate the debt/equity and capital/ordinary distinctions any time soon.[141] While we wait for the time, if ever, that Congress will eliminate these distinctions, we should develop an interim system that synchronizes, to the maximum extent possible, the tax treatment of economically equivalent derivatives.[142] As a necessary first step in developing this interim system, we need to construct a coherent set of rules governing the taxation of prepaid forward contracts, particularly those prepaid forward contracts that are settled in cash. As stated above, once these recommendations are in place, we should classify and tax as a forward contract (or a prepaid forward contract) all financial derivatives that are economically equivalent to a forward contract (or a prepaid forward contract).

The interim system should (1) contain practical rules, (2) produce sound results from the standpoint of tax policy, (3) work within the debt/equity and capital/ordinary distinctions, and (4) not require the Service

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introduced into a debt instrument, and the issue of categorization inevitably becomes a quagmire."); Kleinbard, supra note 4, at 946; William D. Andrews, Reporter's Study of the Taxation of Corporate Distributions, 1982 A.L.I. Fed. Income Tax Project 327, 367-70; Daniel Shaviro, Risk-Based Rules and the Taxation of Capital Income, 50 Tax L. Rev. 643 (1995).

141. See Jeff Strnad, Taxing New Financial Products: A Conceptual Framework, 46 Stan. L. Rev. 569, 604 (1994) ("Repairing the major discontinuities and inconsistencies in current law is a task that would require fundamental reform. These discontinuities and inconsistencies arise from aspects of current law that are central to the statutory scheme, such as the debt/equity distinction, the distinction between capital assets and ordinary assets, and the differential treatment of gains and losses by holding period.").

142. Cf. Kau, supra note 131, at 1004:

> The "conversion" of the timing, source and character of an item of income or deduction into one with different timing, source, or character consequences through financial instruments is undoubtedly the root cause of the confusion in [the financial derivatives taxation] area just as it is the inevitable consequence of a tax regime in which distinctions are made between long and short positions in various financial instruments. The confusion arises because of the intuitive sense among tax policymakers and tax practitioners that economically identical transactions should be taxed identically in a rational tax system, a goal not possible to meet under current law where economic arbitrage permits replication of the same cash flow consequences with a variety of instruments each of which is governed by different rules with respect to timing, source and character.

to withdraw or rewrite existing regulations. Although an interim solution is, by definition, imperfect, we need to cure as many tax discontinuities as possible while keeping in mind that a complete overhaul of the Code is, for the time being, not an option.

As the title suggests, this article will only recommend specific changes to the tax treatment of prepaid forward contracts and the classification of equity swaps and certain CDIs.[143] The following recommendations should apply to investors and issuers alike, although the recommendations are geared to eliminate the tax discrepancies which investors, under current law, most often use to their advantage. The recommendations are not, however, designed to apply to securities dealers, who must currently recognize gains and losses on all financial instruments on a mark-to-market basis.[144]

A. *Recommendations for Prepaid Forward Contracts*

1. *Nature of the Problem.*—In a prepaid forward contract, the purchaser advances funds to the seller in exchange for the seller's promise to either (1) deliver the underlying property on the forward date or (2) make a payment on that date equal to the spot price of the underlying property.[145]

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143. This portion of the article does not address CDIs that are only contingent as to interest. If the holder of a CDI is entitled to a return of the principal amount of the note, and the only contingent portion of the holder's return is the interest component of the note, then the note should be taxed in accordance with the CDI regulations, as indicated in the examples contained in these regulations. This treatment is appropriate for two reasons. First, under the present system, the primary alternative to that treatment is a return to the bifurcation regulations. A return to those regulations would be ill-advised because they were both manipulable, as well as complex. See, e.g., Hariton, supra note 68, at 237. Second, and more importantly, there is no significant debt/equity problem in the case of CDIs with contingent interest. Admittedly, one can argue that a CDI that promises the return of principal plus any appreciation in the S&P 500 index looks very much like a zero coupon bond stapled to a cash-settled call option on that index. One must keep in mind, however, that the Code contains provisions that impute interest on obligations for which *there is no stated interest.* E.g., IRC § 483. These provisions do not question the nature of those obligations as debt. Thus, if the Code does not question the characterization of debt instruments that provide for *no interest*, it would be illogical for the CDI regulations to question the characterization of obligations that provide for *contingent* interest. Therefore, CDIs that are contingent only as to the payment of interest should be treated as debt under the CDI regulations.

144. See IRC § 475(a). This article does not recommend changes to the tax treatment of securities dealers. Securities dealers must, with certain exceptions not relevant here, mark all of their positions to market at the end of each taxable year. IRC § 475(a). Thus, securities dealers are not in a position to benefit from the deferral of income and capital gains treatment available to certain holders of derivatives.

145. One of the fundamental questions raised by prepaid forward contracts concerns the proper classification of these contracts. A prepaid forward contract can, in theory, be classified and taxed as a forward contract, an in-kind debt instrument, or a purchase of the

In an arm's length agreement, the purchase price of a prepaid forward contract will be less than the forward price of a nonprepaid forward contract; otherwise, the purchaser will have no incentive to pay for the forward contract in advance.[146]

As a policy matter, to the extent that the purchaser of a prepaid forward contract receives a "discount" in return for advancing funds to the seller prior to the forward date, she should recognize interest income. After all, that purchaser incurred an obligation to make an expenditure in the future and funded that obligation thorough a current payment made at a discount. This purchaser should not be allowed to characterize interest income as capital gain simply because she loaned money to the seller of the contract and not to an independent third party.[147]

2. *Accounting for Interest: Fully Prepaid Forward Contracts.*—This article recommends that the purchaser of a prepaid forward contract should recognize interest income on the amount of that prepayment. The purchaser should be treated as simultaneously acquiring two financial instruments—a

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underlying property. As can be seen from the debate concerning DECs, reasonable minds can differ on the classification issue. E.g., Sheppard, Things That Go Bump, supra note 4; Sheppard, supra note 108. In the author's opinion, much of the debate concerning the proper classification of prepaid forward contracts derives from the fact that current law provides no mechanism for taxing the interest that accrues on the amount of the prepayment. Because the recommendations in this article provide a method for taxing this interest component, this article will forego a discussion of the issue of classification of prepaid forward contracts under current law.

146. After all, if an investor made a prepayment and did not receive a discount on the forward price, she would be giving up the time value of the prepayment.

147. The following example serves to illustrate this point:

Transaction 1: X only possesses $18. X and Y enter into a two-year forward contract with a price term of $20. X lends $18 to XYZ Co. for two years. XYZ Co. agrees to pay X $1.50 of interest each year and repay the principal at the end of two years. X pays $.50 tax on each of the $1.50 interest payments. At the end of 2 years, X receives her $18 from XYZ and uses that $18 and the $2 of interest remaining after tax to pay the forward price.

Transaction 2: L only possesses $18. L pays N $18 for a two year forward contract which, except for the forward price, is identical to the forward contract between X and Y in Transaction 1.

Under current law, X will recognize interest income as she receives interest payments from XYZ Co. L, however, will not recognize interest income; rather, assuming the parties settle the contract in cash, L will recognize capital gain or loss under § 1234A computed with reference to her $18 basis in the contract. Thus, L has converted ordinary interest income into capital gain. These results are inappropriate because, in both transactions, one party lent money to another party, assumed that party's credit risk, and received compensation therefor. It is inappropriate to ignore the loan from L to N simply because N is the party with whom L entered into a forward contract.

zero coupon bond and a nonprepaid forward contract.[148] That is, that purchaser should be treated as: (1) loaning money to her counterparty in return for her counterparty's promise to repay those funds, with interest, on the forward date; (2) simultaneously entering into a nonprepaid forward contract; and (3) satisfying her obligations under that nonprepaid forward contract with the proceeds she receives upon repayment of the loan.

A two-step approach should be used to determine the amount of interest that the purchaser should recognize on the zero coupon bond component of the prepaid forward contract. First, if one can compute the forward price of the contract in the absence of a prepayment (the "true forward price"), then the purchaser should be treated as purchasing a zero coupon bond that guarantees a payment on the forward date equal to the true forward price. The purchaser should then be subject to tax under the OID rules without regard to the exceptions contained in section 1271(b)(1) (relating to obligations issued by natural persons) and section 1272(a)(2)(E) (relating to loans between natural persons).[149]

Second, if the true forward price cannot be determined with reasonable accuracy, then one must reconstruct the true forward price. In order to do so, one must, logically, add to the amount of the prepayment the total amount of interest that the seller would have to pay had he borrowed the prepayment amount from the purchaser in an independent transaction.[150] Thus, if the true forward price cannot be determined, the purchaser of the

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148. Requiring a lender of money to accrue interest income on the issue price of an instrument is by no means a revolutionary idea. Cf. David P. Hariton, The Taxation of Complex Financial Instruments, 43 Tax L. Rev. 731, 786 (1988) ("The amount of money which unrelated parties pay each other for the use or forbearance of money follows objectively from the application of market rates of interest to the issue price of the instrument and not from the timing and variations of the payments under the instrument or from how taxpayers characterize them."). The suggestion that the prepayment amount on a prepaid forward contract represents a loan is likewise no revolutionary statement. See Stephen B. Land, Contingent Payments and the Time Value of Money, 40 Tax Law. 237, 246 (1987) ("An implicit loan arises whenever an item of income or expense is paid in a period other than the period in which the income can fairly be said to have been earned, or the expense incurred, in an economic sense.").

149. IRC §§ 1271(b)(1), 1272(a)(2)(E). These recommendations should be limited to forward contracts with a duration of one year or more, because the administrative burden to compute the interest on a short term obligation would be excessive.

150. Although somewhat inexact, one must recognize that any approach to the taxation of financial instruments will have drawbacks. See Hariton, Contingent Debt, supra note 68, at 1239 ("[I]t is not going to be easy to determine a reasonable rate of return for any contingent debt instrument, regardless of the issuer's size. The Service would do well to base the reasonable rate of return on the yield of noncontingent debt of the same issuer, where that is available, and provide some percentage of the applicable federal rate (taking term, even credit rating, into account) as a fallback.").

prepaid forward contract should be treated as purchasing a zero coupon bond that provides for interest at the borrower's interest rate.[151] As an alternative, the purchaser should be treated as purchasing a zero coupon bond that provides for interest equal to the AFR or some multiple thereof.

3. *Computing Gain or Loss*

a. *Basis Computation.*—The purchaser of a prepaid forward contract will receive a basis in the zero coupon bond component of the contract equal to the amount paid for that bond (i.e., the prepayment amount).[152] That basis will be increased periodically to reflect the accrual of interest income.[153]

b. *Gain or Loss on Sale Prior to Forward Date.*—If the purchaser of a prepaid forward contract sells that contract prior to the forward date, then she should recognize ordinary interest income to the extent of the accrued but unrecognized OID on the zero coupon bond.[154] Any excess of recognized gain over the amount of accrued but unrecognized OID should be treated as capital gain, as that gain represents an increase in the projected forward price of the underlying property, which upon acquisition would be a capital asset in the hands of the purchaser.[155] Any loss on the sale of the prepaid forward contract should likewise be treated as capital.

c. *Gain or Loss on Cash-Settlement or Subsequent Sale of the Underlying Property.*—If the purchaser does not sell the forward contract prior to the forward date, then she will be deemed to: (1) receive the entire amount of principal and interest upon maturity of the zero coupon bond; and (2) simultaneously make a payment, equal to the deemed amount received, in satisfaction of her obligations under the hypothetical nonprepaid forward contract. The purchaser will not be subject to tax upon receipt of the principal and interest components of the zero coupon bond, because the adjusted basis

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151. For a logical approach to determining the borrower's interest rate, see Hariton, Contingent Debt, supra note 68, at 1242.

152. See IRC § 1012.

153. See IRC § 1272(d)(2) ("The basis of any debt instrument in the hands of the holder thereof shall be increased by the amount included in his gross income pursuant to this section.").

154. See Regs. § 1.61-7(d) ("When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of the sale and must be reported as interest income. Amounts received in excess of the original issue discount upon the retirement or sale of a bond . . . may under some circumstances constitute capital gain instead of ordinary income.").

155. Regs. § 1.61-7(d).

of that bond will be equal to the sum of the principal and interest payments made at maturity.[156]

If the parties settle the forward contract in cash, then the purchaser will recognize gain or loss under section 1234A;[157] her basis for purposes of section 1234A will be the amount of principal and interest received upon maturity of the zero-coupon bond.[158] If the purchaser takes delivery of the underlying property, then she will take a basis in that property equal to the sum of the principal and interest payments that she received upon maturity of the zero coupon bond.[159]

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156. See IRC § 1272(d)(2).

157. See supra notes 32-35 and accompanying text.

158. IRC § 1012.

159. IRC § 1012. The cost of the underlying property is equal to the true forward price of the contract which, in turn, is equal to the sum of the principal and interest payments received by the purchaser upon maturity of the zero-coupon bond.

These basis computations must be made to avoid double taxation. Many commentators suggest that the Service should promulgate regulations under § 446(b) that require the purchaser of a prepaid forward contract to recognize interest income on the prepayment amount. E.g., ABA Report, supra note 139, at 203; Lee A. Sheppard, Clear Reflection for Contingent Payment Securities, 70 Tax Notes 1411 (Mar. 4, 1996). As will be discussed below, however, simply requiring the purchaser of a prepaid forward contract to recognize interest income may prove to be inequitable.

The only drawback to § 446(b) regulations is the possibility that these regulations may result in double taxation of income.

The above recommendations (1) attempt to reconstruct the true forward price of a fully prepaid forward contract, and then (2) treat the purchaser of a prepaid forward contract as if she purchased a zero coupon bond and a nonprepaid forward contract at the true forward price. Thus, these recommendations take account of the fact that, under current law, purchasers of prepaid forward contracts and purchasers of nonprepaid forward contracts compute gain or loss under § 1234A using different cost bases. The recommendations simply (1) recharacterize a portion of the former purchaser's capital gain as ordinary income and (2) require that purchaser to accrue that ordinary income during the period between the prepayment date and the forward date.

Under the § 446(b) approach, however, purchasers of prepaid forward contracts would accrue interest on the prepayment amount. Unless these purchasers are entitled to increase their bases in their forward contracts by the amount of interest accrued on the prepayment amount, they will be subject to double taxation.

> *Example.* F purchases a two-year prepaid forward contract from G for $18. The true forward price is $20. F is required under § 446(b) to accrue $2 of interest income over the two year period. Assume that the pertinent § 446(b) regulations do not provide for a basis adjustment to reflect the amount of interest included in income. On the forward date, F receives a $22 payment from G. F must recognize $4 of capital gain ($22 amount realized minus $18 basis). F recognizes a total of $6 of income from that transaction: $2 of interest income and $4 of capital gain. Two dollars of that $4 gain represent compensation to F for the use of F's money. Thus, X is taxed twice on the same income.

4. *What About Partially Prepaid Forward Contracts?*

a. *The Time Value Issue.*—In certain cases, an investor may be able to partially prepay a forward contract. In such a case, the forward contract will likely contain a price term that is less than the true forward price. The difference between the true forward price and the actual forward price of the partially prepaid forward contract represents interest received by the purchaser of the partially prepaid forward contract. This purchaser should be required to accrue that interest under the same rules applicable to fully prepaid forward contracts. She should recognize gain or loss upon the sale or termination of the contract using the same basis calculations applicable to prepaid forward contracts.

b. *Anti-Abuse.*—Although this article does not address the taxation of options, it is necessary to deal with deep in the money call options. A deep in the money option is an option contract in which the holder pays an unusually large option premium in return for receiving an option contract that has a strike price that is significantly less than the current trading price of the underlying property. In order to prevent taxpayers from structuring their way out of these recommendations, deep in the money call options should be classified and taxed as partially prepaid forward contracts.

> *Example.* X Co. stock is currently trading at $20 a share. A pays B $17 in return for a call option on X Co. stock that has a strike price of $1. The option expires in two years.

The option in the above example closely resembles a partially prepaid forward contract, because A has an economic obligation to purchase the stock and that economic obligation is, for all practical purposes, a real obligation. This is because A has paid $17 for the "right" to purchase an asset that he will, in all likelihood, purchase. Under current law, A will not recognize any

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Example. Assume the same facts above, except that the recommendations in this article are in effect. F must accrue $2 of interest income during the two year period between the contract date and the forward date. That $2 of interest is, by operation of the OID rules, added to F's $18 basis in the forward contract. Upon receipt of the $22 payment, F recognizes $2 of capital gain ($22 amount realized minus $20 basis). F recognizes a total of $4 of income from that transaction: $2 of interest income and $2 of capital gain.

The double taxation that results under the first example is unfair. The problem with prepaid forward contracts is that the purchaser is free to defer the receipt of interest income and then treat that interest income as capital gain. These problems should be solved by correcting these timing and character distortions without subjecting the same item of income to double taxation. Thus, if the Service promulgated regulations under § 446(b) that adopted the above recommendations, it would have to be cognizant of the potential double taxation issue.

interest income on that option premium. Thus, A could effectively avoid the above recommendations. There is no real distinction between a deep in the money option and a partially prepaid forward contract. We should draw a bright line between deep in the money options and in the money options, perhaps based on the percentage of the current trading price that is paid as an option premium, and treat deep in the money call options as partially prepaid forward contracts.

B. *Recommendations for Gold Notes*

The following section of this article will (1) provide a set of rules for the taxation of gold notes and two CDIs that constitute variations of the gold note, and (2) apply these rules to the gold note and the two variations.

1. *Gold Notes With Fully Contingent Principal and Interest.*—Where the principal and interest components of an obligation are contingent upon the value of some other asset, the obligation should not be treated as debt. Contingent principal should be viewed as the antithesis of debt. That does not mean, however, that the obligation should be viewed as equity *in the issuer* of the obligation in question.[160]

When analyzing the tax treatment of the purchaser of a gold note, one must determine the nature of the purchaser's investment.[161] A gold note is practically identical to a cash-settled, prepaid forward contract on gold. An investor who purchases a gold note receives the same *legal* rights that she would have received had she purchased a cash-settled, prepaid forward contract on the underlying property. That is, neither the purchaser of a gold note, nor the purchaser of a cash-settled, prepaid forward contract on gold, is *entitled to receive the underlying property.* Rather, the purchaser of a gold note and the purchaser of a cash-settled, prepaid forward contract on gold

160. The issues in this article center, for the most part, around the timing and character of income from CDIs. The source issue has, for the most part, been relegated to the back burner. The timing and character issues have, however, been the subject of much debate among the commentators. New York State Bar Association Tax Section & ABA Tax Section, supra note 74, at 1242-45. The author believes that much of this debate results from the absence of a framework for the taxation of cash-settled, prepaid forward contracts. Under current law, at least *some* portion of the gain or loss from the sale or cancellation of a prepaid forward contract will, in the hands of a private investor, qualify as capital. IRC § 1234A. Therefore, the classification of some portion of the return from a CDI that resembles a cash-settled, prepaid forward contract as capital gain should not spark controversy. The only question is the extent to which that return should be classified as capital.

161. To the extent that the gold note does not have an underlying property, it seems fair to say that the purchaser of such a note has made a loan followed by a bet. For example, if Y lends $1,000 to Z in return for either $1,000 or $0, depending on the roll of a dice on the maturity date of the loan, Y has really loaned Z $1,000 for adequate interest and then wagered the proceeds of that loan. See Hariton, supra note 148, at 733-38.

both receive the same thing—the right to a payment in the future equal to the spot price of a certain amount of gold. Hence, both of these purchasers receive only *creditors' rights* against their respective counterparties.[162]

The gold note should be classified and taxed as a cash-settled, prepaid forward contract on gold.[163] The basis for this assertion does not lie in the realm of "form over substance." Because a gold note and a cash-settled, prepaid forward contract on gold are identical in both form and substance, the *label* that the parties attach to the gold note should be disregarded. Simply put, the Code should not permit an investor to manipulate the timing, character, and source of her income simply by altering *the label* attached to (as distinguished from the *form* of) her investment.

2. *Gold Notes With Fully Contingent Principal and Noncontingent Interest.*—A gold note could conceivably provide for periodic interest payments followed by a payment at maturity equal to the value of a certain amount of gold (a "guaranteed interest gold note"). Because the repayment of principal on a guaranteed interest gold note is fully contingent, that instrument should be treated as a loan coupled with a cash-settled, nonprepaid forward contract.[164] If the recommendations in this article were adopted, a guaranteed interest gold note would not be taxed any differently than a gold note. This is because the purchaser of a gold note will be required to accrue interest income between the purchase date and the forward date. Because the guaranteed interest gold note already provides for periodic interest payments, the purchaser of that note will include these interest payments in income as they are received. The amount of gain or loss recognized by a purchaser of a guaranteed interest gold note upon the maturity of that note should not differ from the amount of gain or loss recognized by the purchaser of a gold

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162. This analysis raises an interesting question: Are cash-settled, prepaid forward contracts CDIs subject to the CDI regulations? The author believes that we should focus on recharacterizing the gold note as a cash-settled, prepaid forward contract rather than the reverse, because investors may agree to cash settle a forward contract at some time *after* the execution of the contract. Drawing a distinction between the situation where the parties agree upon execution of the contract to settle the contract in cash and the situation where the parties agree at some later time to settle the contract in cash would further open the door to selective taxation.

163. As will be discussed below, this recommendation takes account of the capital contract component of the gold note, see Hariton, Contingent Debt, supra note 68, at 1231, while at the same time insuring that economically equivalent financial instruments give rise to income that is identical as to character *and* source.

164. This rule should apply even if the sum of the interest payments equals the issue price of the note. In that case, the purchaser would be required to accrue the interest over the life of the loan and then recognize capital gain or loss on maturity. This is the easiest way to tax the time value component of the note.

note, because the amount of gold underlying the guaranteed interest gold note would be reduced to reflect the fact that the issuer of that note must make periodic interest payments to the purchaser.

3. *Gold Notes With Partially Contingent Principal*

a. *Introduction.*—Assuming that the above recommendations represent sound tax policy, one must address a much harder question: What is the appropriate tax treatment of an instrument with respect to which *only a portion* of the *principal* is contingent (a "gold note with NCP" (noncontingent payments))? In order to answer that question, one must first classify a gold note with NCP as either debt or something other than debt. That classification is difficult to determine because, so long as there are different rules for contingent and noncontingent principal obligations, investors will be able to subject themselves to the set of rules that is most advantageous to them.[165] One must keep in mind, however, that the current state of affairs is both unacceptable (insofar as it accords different tax treatment to instruments that are identical in both form and substance) and unlikely to undergo any *significant* changes in the foreseeable future.[166] The best course of action is to identify the minimum amount of *principal* that the issuer must be obligated (by the terms of the note) to return in order for a gold note with NCP to qualify as *debt*. If, for example, 90%[167] were chosen

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165. Cf. Hariton, New Rules, supra note 68, at 235 (criticizing the bifurcation regulations as inadequate, because, under those regulations, it is so easy "to steer in and out of bifurcated treatment that the [bifurcation regulations] may prove a bonanza for financial engineers").

166. But see Haskins, supra note 71, at 544 (suggesting that Congress may reform the tax treatment of corporations and eliminate the distinction between debt and equity). Mr. Haskins' suggestion came in the wake of the 1994 congressional elections, when it appeared that tax reform might actually occur. Given the results of the 1996 elections, however, the possibility of significant tax reform along the lines suggested by Mr. Haskins seems remote (at best).

167. The author acknowledges that this number is completely arbitrary. One must, however, draw the line somewhere. After analyzing the debt/equity cases, and reading the seminal "Plumb Article" on the debt/equity distinction, the author's opinion is that a bright line is superior to a facts-and-circumstances analysis. This bright line test will hopefully eliminate some of the uncertainty that plagues other financial instruments. See, e.g., Robert Willens, Unbundling Securities: Searching for a Coherent Policy, 53 Tax Notes 1513, 1513 (Dec. 30, 1991) ("Two securities which have gained widespread popularity, namely PERCs and so-called 'R&D . . . Units,' are heavily penalized by the lack of certainty attending the manner in which they are properly taxed. In fact, this lack of clarity is a pervasive problem faced by investment bankers and their counsel charged with the responsibility of designing and marketing new financial products."); cf. David P. Hariton, More on Bifurcation of Contingent Debt, Letters to the Editor, 51 Tax Notes 1075, 1076 (May 27, 1991) ("The very thought of writing a public

as the minimum amount of principal, a gold note with NCP with a $1,000 issue price and minimum return of $900 of *principal* would be treated as a debt instrument; if that note promised a minimum return of $989 or less of *principal*, then the instrument would be treated as something other than debt.

Once it is established that a gold note with NCP is "something other than debt," one must determine exactly what that note is.[168] At this point, three alternatives arise. First, one could simply ignore the noncontingent component of the note and treat the note as a standard gold note. Second, one could treat the instrument as consisting of a zero coupon bond coupled with a cash-settled call option on the underlying property. That solution ("the bifurcation approach") is an extension of the bifurcation regulations. Third, one could treat the instrument as consisting of a cash-settled, prepaid forward contract on the underlying property coupled with a cash-settled put option on that property. That alternative is an offshoot, rather than an extension, of the underlying rationale of the bifurcation regulations.

The first alternative, although simple, is unacceptable. One cannot ignore a noncontingent payment for the purpose of convenience. This is because, as will be discussed below, the purchaser of a gold note with NCP most likely paid for the noncontingent payment right by foregoing a certain amount of interest on the money that she loaned to the issuer.[169] From the standpoint of accurately determining the purchaser's income, it would be imprudent to ignore the noncontingent payment right.

There are three reasons why the bifurcation approach should not be adopted. First, under the bifurcation approach, the purchaser will allocate a portion of the purchase price of the note to a hypothetical zero coupon bond and the remaining portion of the purchase price to premium on a hypothetical call option. Under current law, the purchaser will accrue interest on the portion of the purchase price allocated to the zero coupon bond, but will not accrue interest on the portion of the purchase price allocated to the call option. Thus, under the bifurcation approach, the purchaser will not accrue interest on the entire amount of money actually advanced to the issuer. Second, the parties to a CDI can manipulate the amount of basis allocated to

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disclosure setting out the 10 possible ways in which an instrument can be divided into component parts and how each component part would be taxed if it was among those chosen by the Internal Revenue Service (only to have someone burst into my office with an eleventh) makes me shudder. As for the success of the common law approach in *Lucas v. Earl*, the Supreme Court's decision in *Arkansas Best*, and the myriad cases fleshing out the distinction between equity and debt are better examples of how this [common law] approach [to classifying financial instruments] works in the realm of complex financial transactions.").

168. The proper classification and taxation of gold notes with NCP is of practical importance because issuers of publicly traded commodity-indexed obligations typically provide for a minimum fixed principal payment at maturity. See Land, supra note 148, at 238 n.5.

169. See infra note 177.

the long call option, and thereby maximize the portion of the issue price on which interest will not accrue, simply by manipulating computation of the present value of the hypothetical zero coupon bond.[170]

There exists a third, and more compelling, reason for not applying the bifurcation concept in connection with the recommendations espoused in this article: The above recommendations would treat the gold note as a cash-settled, prepaid forward contract *for all purposes of the Code*. This means that gold notes would qualify as positions in property within the meaning of section 1092. The hypothetical zero coupon bond contained in the gold note with NCP would not be subject to section 1092. Thus, if the bifurcation approach were to apply to gold notes with NCP, taxpayers would be free, to a certain extent, to structure their way out of section 1092 simply by purchasing a gold note with NCP.[171] Therefore, the author would apply the third alternative to gold notes with NCP.

b. *The Modified Bifurcation Approach*

i. *Introduction.*—The third alternative (hereafter, the "modified bifurcation approach") is similar to the bifurcation approach insofar as it classifies a gold note with NCP as a combination of two positions. As will be discussed below, however, the modified bifurcation approach is superior to the bifurcation approach for two reasons. First, the modified bifurcation approach provides a simpler method for allocating the purchase price of the gold note with NCP between the prepaid forward contract and put option components of that note. Second, the modified bifurcation approach will not permit taxpayers to structure their way out of section 1092.

Under the modified bifurcation approach, the prepaid forward contract and the hypothetical long put option would be treated as a single position. That is, the purchaser of a gold note with NCP would not recognize capital gain or loss on the note until either the sale or maturity of the note. The amount of that gain or loss would be computed with reference to the

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170. See Lokken, supra note 68, at 498-99 (indicating, through examples, that the bifurcation approach leads to inappropriate results in certain instances). For example, as the present value of the guaranteed payment decreases, the amount of basis assigned to the zero coupon bond decreases and the amount of basis assigned to the option increases, and vice versa. Thus, under the bifurcation approach, the parties could manipulate the amount of ordinary income and capital gain recognized by the purchaser by distorting the calculation of the present value of the zero coupon bond component of the gold note with NCP.

171. One must distinguish the hypothetical zero coupon bond referenced above from the zero coupon bond component of a prepaid forward contract. The former exists separately from any other contractual right, and is therefore not subject to the straddle rules. The latter only exists as one component of a prepaid forward contract, which contract, in and of itself, is potentially subject to the straddle rules.

combined basis of the forward contract and the put option, and the character of that gain or loss would be determined by reference to the nature of the underlying property.[172]

ii. *Application of the Modified Bifurcation Approach.*—In applying the modified bifurcation approach, one need not confront the allocation problems that plague the bifurcation approach.

Under the modified bifurcation approach, the entire purchase price of the gold note with NCP is allocated to the prepaid forward contract component of the note. This allocation rule is premised on the notion that, in order to obtain the noncontingent payment right (i.e., the put option), the purchaser of a gold note with NCP gives up a portion of the return to which she would have otherwise been entitled. In order to account for the fact that the purchaser of a gold note with NCP pays for the put option by forfeiting a portion of her future return, the purchaser should be treated as: (1) purchasing a prepaid forward contract in cash, (2) purchasing the long put option on credit from the seller of the gold note with NCP,[173] and (3) paying for the put option with *a portion* of the interest that accrues on the prepayment amount (i.e., that amount of interest that the purchaser gave up in order to obtain the noncontingent payment right). Thus, the *entire* purchase price of the gold note with NCP is allocated to the forward contract component of that note.[174] Therefore, no difficulty would be encountered

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172. IRC §§ 1234(a) (with respect to a purchased option contract, character of gain or loss is determined by reference to the nature of the underlying property in hands of the holder), 1234A (with respect to forward contracts, the nature of gain or loss on cancellation of the contract is determined by reference to the nature of the underlying property in hands of the taxpayer).

173. One may inquire as to the basis of the put option. The basis of that option could only be relevant where the purchaser sells the gold note with NCP prior to the maturity date of that note. In theory, because the purchaser of a gold note with NCP acquired the put option on credit from the seller, she should be required to include in her amount realized the remaining "principal amount" on the "purchase money note" with which she acquired the put option. The purchaser need not do that, however, because, as discussed infra notes 175-177 and accompanying text, she will, over time, *allocate* a portion of the interest that accrues on the issue price of the note to the long put option. Thus, where the purchaser sells the gold note with NCP prior to maturity, she simply gives up her right to future unaccrued interest on the issue price of the note and does not experience a cancellation of indebtedness in the conventional sense. Thus, the purchaser need not include in her amount realized any portion of the future interest that would be allocated to the put option, as that interest amount will be realized by the transferee of that note and then allocated to the put option.

174. This recommendation is similar in some ways to the suggestions made by other commentators. See, e.g., Hariton, New Rules, supra note 68, at 238 (suggesting that holders of CDIs should (1) accrue interest on the entire purchase price of the CDI, and (2) recognize capital gain or loss on the difference between the amount received on maturity of the CDI and

in determining the prepayment amount of the prepaid forward contract. More importantly, the purchaser would be required to accrue interest on the entire amount of money that she advanced to the issuer.[175]

> *Example.* B purchases a gold note with NCP from Z Co. for $1,000. The note provides for one payment at maturity equal to the greater of $500 or 3.5 ounces of gold. B is treated as purchasing a prepaid forward contract for $1,000 and a put option on credit. B accrues interest income on the $1,000 prepayment over the life of the gold note with NCP. B is treated as receiving the interest income and then allocating a portion of the interest payments to the "purchase money note" used to acquire the put option. Upon maturity, B's basis in the put option is equal to the sum of the interest payments allocated to the put option. Upon maturity, B's basis in the forward contract is equal to the sum of the purchase price of the gold note with NCP and the interest payments that were *not* allocated to the put option. Upon maturity, B will recognize gain or loss with reference *to the combined basis* of the forward contract and the put option. The basis will be equal to the sum of (1) the issue price of the gold note with NCP and (2) the amount of imputed interest income on the zero coupon bond component of the forward contract.[176]

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the sum of the issue price and accrued interest amounts); Hariton, supra note 167, at 1075; Reed Shuldiner, A General Approach to the Taxation of Financial Instruments, 71 Tex. L. Rev. 243 (1992) (addressing timing problems raised by complex financial instruments through the use of an expected value taxation system). These approaches did not, however, address the sourcing issues posed by CDIs. More importantly, they apparently would not treat a gold note, or any of the gold note variations discussed in this article, as a "position in personal property" within the meaning of § 1092. See supra note 87. This means that, unless gold notes are positions in personal property under current law, an investor would potentially be free, under the above approaches, to structure her way out of the straddle rules by moving from a cash-settled, prepaid forward contract on gold to a gold note. See supra note 87. For these two reasons, the recommendations in this article, although somewhat more complicated, are superior from a policy perspective to the above approaches.

175. In determining the amount of interest to be accrued on the prepayment amount (i.e., the zero coupon bond component of the prepaid forward contract), one would have to disregard the quantity of the underlying property referenced in the gold note with NCP. This is because that quantity was (most likely) decreased by the issuer of the note to reflect the fact that the holder is entitled to a guaranteed minimum payment.

176. The author would treat the purchaser of a gold note with NCP as receiving the put option on credit from the seller, and then repaying that loan with *a portion of* the imputed interest payments that the purchaser receives on the zero coupon bond component of the prepaid forward contract. This approach, in essence, requires the purchaser of a gold note with NCP to allocate a portion of the interest payments between the basis of the put option and the basis of the zero coupon bond. This approach results in an understatement of the basis of the zero coupon bond. Moreover, an allocation of basis such as the one above would not occur

iii. *Critique of the Modified Bifurcation Approach.*—The main weakness in the modified bifurcation approach is that it treats the purchaser as purchasing an option on credit. This is a somewhat novel approach, because the holder of an option usually must pay an option premium up front. There is no reason, however, why a holder cannot purchase an option with an installment obligation.[177]

The main disadvantage of this approach, from the standpoint of the purchaser, is that the purchaser will be required to recognize more interest income than she is actually entitled to receive under the terms of the gold note with NCP. However, this treatment is appropriate because the purchaser of a gold note with NCP necessarily forfeits future interest (on the zero coupon bond component of the prepaid forward contract) in return for a guaranteed minimum payment.[178] Otherwise, the issuer of the note would have no incentive to offer such a payment. It therefore is appropriate to treat a purchaser of a gold note with NCP as (1) receiving all of the interest to which she would otherwise be entitled, and (2) purchasing the right to noncontingent payments (i.e., the long put option) with a portion of that interest.

In the end, this approach will accord the purchaser of a gold note with NCP a higher integrated basis than she would have had if she had been

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if the forward contract and the put option components of the gold note with NCP were purchased separately. However, the issuer of the gold note with NCP understated the payment to which the purchaser is entitled at maturity because, in the absence of the noncontingent payment right, that payment at maturity would have been larger. Because this approach would not require the parties to a gold note with NCP to gross up the payment at maturity to reflect the fact that it has been artificially reduced, no adjustment is necessary to the basis of the zero coupon bond component of the forward contract to reflect the fact that it too has been artificially reduced. In essence, given the integrated nature of the forward contract and the put option, the discrepancies in basis will come out in the wash.

177. In fact, many commentators note that investors who purchase debt instruments with embedded options often receive less interest income than they would have received had they purchased a debt instrument without the embedded option; that is, investors can purchase embedded options with foregone interest. Kau, supra note 131, at 1004 ("Because convertible debt can be economically analyzed as straight debt with an option, a holder can be viewed as having paid for the [embedded] option by foregoing a market rate of interest for the term of the bond."); Hariton, supra note 148, at 780 ("Under current law, less is deemed to be paid for the use or forbearance of money when it is borrowed under a convertible debt obligation."). In addition, where an investor purchases a share of preferred stock, such as a PERC, which is the equivalent of a share of common stock and a short call option, the investor will not receive an option premium for that short call option; rather, that investor will receive more dividend income from that instrument than she would have received had she purchased a share of stock that did not have an imbedded short call option. Edward D. Kleinbard, What's New with Financial Products?, 334 PLI/Tax 9, 37 (WESTLAW, PLI-TAX) (1992).

178. See supra note 177 (purchasers of debt instruments that contain embedded options typically forego interest income in return for that embedded option).

required to bifurcate the purchase price of that note between the forward contract and the put option. This means that the purchaser will, upon maturity of that note, recognize less capital gain or more capital loss than she would have recognized had she been required to bifurcate the purchase price between the forward contract and the long put option. That potential advantage, however, is effectively eliminated through the periodic accrual of interest on the full issue price of the gold note with NCP.[179]

4. *Effect of the Straddle Rules*

a. *Background.*—A less obvious effect of the above recommendations is that gold notes will definitely constitute "positions" in property and will, in certain cases, be subject to the straddle rules contained in section 1092.[180] The term "straddle" refers to the situation in which a taxpayer holds two or more positions in the same property that, economically,

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179. It may be prudent, however, to include an anti-abuse rule in the rules applicable to gold notes with NCP. After all, the Service learned the hard way that taxpayers can, for tax avoidance reasons, structure their way into regulations that front load income and back load basis recovery. For example, the Service recently won a Tax Court case in which a partnership known as "ACM," which was formed by the Colgate-Palmolive Company [hereinafter Colgate] and Merrill Lynch, entered into a series of transactions that were designed to take advantage of Temp. Regs. § 15A.453-1(c). ACM Pship., Southhampton-Hamilton Co. v. Commissioner, 73 T.C. Memo (CCH) 2189, T.C. Memo (RIA) ¶ 97,115 (1997); see Steven M. Surdell, The Role of Business Purpose in Complex Financial Transactions—ACM Partnership v. Comr., Special Edition, Corporate Tax and Business Planning Review, 37 Tax Mgmt. Memo. S-311 (Nov. 25, 1996). That regulation provides for ratable basis recovery in the case of installment sales that contain a contingent sales price. By providing for ratable basis recovery, that regulation will mandate a large gain recognition in early years and large loss recognition in later years where the taxpayer receives a large noncontingent payment in an early year and a small contingent payment in a later year. ACM wanted to generate present income and future losses, and it therefore structured its way into Temp. Regs. § 15A.453-1(c). The Service was forced to litigate the issue of whether a taxpayer must show some bona fide business purpose in order to fall within that regulation. Lee A. Sheppard, Colgate's Corporate Tax Shelter Showdown, 71 Tax Notes 1284 (June 3, 1996); Lee A. Sheppard, Court Hears Final Arguments in Colgate Tax Shelter Case, 96 TNT 107-3 (May 31, 1996) (LEXIS, FEDTAX library, TNT file). Perhaps, if that regulation had contained an anti-abuse rule, the Service would have had an easier time litigating its case.

The author is not clever enough to envision every case in which a taxpayer would want to recognize large amounts of interest income presently and large amounts of capital losses in the future. In that corporations can act as investors, one realizes that it is not terribly difficult to envision a handful of such situations. For example, a taxpayer may wish to front load ordinary income in order to use up expiring net operating losses and then defer a capital loss into the future in order to soak up capital gains. Therefore, the author would include an anti-abuse rule in the above recommendations.

180. See supra note 87 (under present law, it is unclear whether gold notes are positions in personal property within the meaning of the straddle rules).

behave in opposite ways.[181] In a straddle, one position will reduce the risk of loss (or opportunity for gain) inherent in the other position.[182] For example, if a taxpayer enters into a long forward contract to purchase a barrel of oil for $10 and then enters into a short forward contract to sell that barrel of oil to someone else for $10, the taxpayer is in a straddle. That is because, as the value of that barrel of oil increases beyond $10, the taxpayer's long forward contract (i.e., the purchase contract) increases in value, whereas the short forward contract (i.e., the sale contract) decreases in value; as the value of that barrel of oil decreases below $10, the taxpayer's long forward contract decreases in value, and the short forward contract increases in value.

Section 1092(a) defers the recognition of certain realized losses in cases where the taxpayer has an unrecognized gain in one or more offsetting positions.[183] Thus, if a taxpayer is in a straddle, she will not be able to recognize loss on one position in that straddle to the extent that there exists unrecognized gain in another position in that straddle.[184]

It is important to note that the straddle rules apply to positions in property *for which* there is an established market. Therefore, even if a particular gold note is executed by private parties and is not an actively traded security, that gold note will be subject to the straddle rules if *the underlying property* is an actively traded asset.

b. *Fully Contingent Gold Note.*—Under the above rules, if a taxpayer holds both a gold note and an offsetting (viz., short) position with respect to gold, then the taxpayer will not be able to recognize any loss on either of these two positions to the extent that there is unrecognized gain in the other position.

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181. See 2 Kramer, supra note 58, at 1211.

182. See 2 Kramer, supra note 58, at 1211.

183. IRC § 1092(a)(1). Section 1092(c)(2)(A) provides:

> A taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind).

184. IRC § 1092(a). Section 1092(d)(2) provides that "the term 'position' means an interest (including a futures or forward contract or option) in personal property." Section 1092(d)(1) defines personal property as "any personal property of a type which is actively traded." Regulations section 1.1092(d)-1(a) states, "[a]ctively traded personal property includes any personal property for which there is an established financial market." Subsection (b) of that regulation states that the term "established financial market" includes: (1) a national securities exchange, (2) an interdealer quotation system, (3) a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission, (4) certain foreign securities exchanges, (5) an interbank market, (6) an interdealer market, and (7) (solely with respect to debt instruments) a debt market. Regs. § 1.1092(d)-1(b).

Example. B purchases a gold note with a ten year maturity for $1,000. That note entitles B to the value of 4 ounces of gold. B then enters into a short, cash-settled forward contract on gold. Prior to the maturity date of the gold note, B cancels the short forward contract for a $500 loss. Section 1092(a)(1) defers that loss to the extent of the unrealized gain in the gold note. That is, if, on the last business day of the taxable year in which B canceled the short forward contract, the fair market value of the gold note exceeds B's basis therein, then the loss on the forward contract will be deferred to that extent.[185]

c. *Gold Notes With NCP*—The following paragraphs will analyze the application of the straddle rules to investors who purchase a gold note with NCP and then subsequently (1) purchase a put option on gold or (2) sell a call option or forward contract on gold.

This article recommends that gold notes with NCP be treated as a single position consisting of a long forward contract and a long put option. If the purchaser of a gold note with NCP enters into another position, such as a freestanding long put option, that is offsetting with respect to the long forward contract component of the gold note with NCP, then the purchaser will not be able to recognize loss on the freestanding long put option to the extent there is unrecognized gain in the gold note with NCP, and vice versa.[186]

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185. If the offsetting positions in the above example were gold futures contracts subject to § 1256, then the taxpayer could elect to have § 1256 not apply with respect to those futures contracts. If the taxpayer did not make that election, then any losses recognized under the mark-to-market regime would be deferred under § 1092 unless the taxpayer elected to utilize straddle-by-straddle identification or a mixed straddle account under § 1092(b)(2). Either of those alternatives are beyond the scope of this article.

186. See IRC § 1092(c)(2)(A). The long put option imbedded in the gold note with NCP decreases at least some of the risk of loss inherent in holding a long forward contract on gold. An investor can encounter straddle problems if she purchases a gold note with NCP and then subsequently purchases a put option on gold ("free-standing put option"). If the free-standing put option eliminates the risk of loss *remaining* in the gold note with NCP, then the free-standing put option should be subject to the straddle rules. If, however, the free-standing put option has a strike price that exceeds the difference between the price paid for the gold note with NCP and the noncontingent payment on that note, then (1) the taxpayer has increased her risk of loss to the extent of the premium paid for that excess, and (2) the taxpayer should not be subject to the straddle rules for the loss recognized with respect to that excess premium.

These conclusions employ the word "should" instead of "will" for a simple reason. Section 1092(c)(2)(B) provides "[i]f 1 or more other positions offset only a portion of 1 or more positions, the Secretary shall by regulations prescribe the method for determining the portion of such other positions which is to be taken into account for purposes of this section."

An investor can also enter into a position that eliminates her opportunity for gain (i.e., a short position) on the forward contract component of the gold note with NCP. For example, an investor could purchase a gold note with NCP and then either (1) write a cash-settled call option on gold or (2) enter into a short, cash-settled forward contract on gold. If that investor terminates either of these short positions at a loss, then she will not be able to recognize that loss to the extent there is unrecognized gain in the gold note with NCP, and vice versa.[187]

C. *Recommendations for Equity Swaps*

1. *Recommendations*

a. *Introduction.*—The main difference between gold notes and equity swaps is that there exists a system governing the *timing* of income from equity swaps. This article does not recommend changing that timing system. Rather, this article only recommends changes to the rules governing the character and source of income from equity swaps. With respect to a private investor who purchases a long equity swap from another private investor, the main issue will center on whether that other private investor liquidated any investment that she may have had in the underlying property.[188] That issue is beyond the scope of this article.

b. *Character.*—Long equity swaps should be treated for tax purposes as a series of cash-settled forward contracts. Therefore, the character of items of income, as well as loss, from equity swaps should be determined under section 1234A.

If the purchaser of a long equity swap also purchases the right to receive a minimum amount of income from her counterparty, then the equity swap should be treated in the same way as a gold note with NCP.[189] These two recommendations will insure that equity swaps receive the same tax

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The Service has yet to issue regulations under that section. Thus, it appears that, if a position, such as the free-standing put option, is only offsetting with respect to a portion of another position (e.g., a long forward contract), any loss on such position will be deferred to the full extent of the unrecognized gain in that other position.

187. See supra note 186.

188. See Bruce Kayle, Will the Real Lender Please Stand Up? The Federal Income Tax Treatment of Credit Derivative Transactions, 50 Tax Law. 569, 579 (1997).

189. The right to receive a specific amount of money under a notional principal contract is known as a "floor." A floor is economically equivalent to a series of cash-settled put options. For that reason, where an investor enters into an equity swap that entitles him to a minimum return on each swap payment (or the equity swap as a whole), the swap and the floor should be coupled, and any gain or loss on that position should be treated as capital under §§ 1234(a) and 1234A.

treatment accorded gold notes, and that equity swaps with floors will receive the same tax treatment as gold notes with NCP.

c. *Source.*—Equity swaps should be subject to the same sourcing rules applicable to forward contracts. For example, a long equity swap into U.S. real estate should be sourced in the same manner as a long forward contract on U.S. real estate. To the extent that the sale or exchange of a *forward contract* would give rise to foreign source income, then the payments received under an equity swap should give rise to foreign source income.

The above discussion indicates that sourcing *all* equity swap income to the residence of the recipient can give rise to abuse.[190] This article recommends that the portion of an equity swap payment that represents income from the underlying property (e.g., dividends) should be (1) treated as a separate payment outside the equity swap and (2) sourced in the same way as the income from the underlying property would otherwise be sourced.[191] This treatment is appropriate for two reasons: First, an equity swap is supposed to be the economic equivalent of a series of cash settled forward contracts, and forward contracts do not entitle the purchaser to income from the underlying property. Second, foreign investors should not

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190. *Example.* J, a nonresident alien individual, purchases stock in L Co., a U.S. corporation. J also purchases an equity swap on the stock of Y Co., a U.S. corporation.

The equity swap entitles J to the appreciation and dividends on Y Co. stock; in return, J agrees to pay the counterparty the depreciation on Y Co. stock and interest at a specified rate. L Co. declares a dividend, and J pays a 30% tax on that dividend. IRC §§ 861(a)(2) (dividends from a U.S. corporation are U.S. source income), 871(a) (a nonresident alien individual must pay 30% tax on U.S. source dividend income). Y Co. declares an equally large dividend, and the counterparty to J's equity swap makes a payment to J in an amount equal to that dividend. Under the current sourcing rules, J does not pay any U.S. tax on the dividend equivalent payment under the equity swap.

191. One might argue that it is inappropriate to tax both the holder of a share of stock and the purchaser of an equity swap into that stock on the same dividend declaration. Consider the case, however, of a tax-exempt entity, such as a pension fund, or a tax-exempt person, such as a foreign national who lives in a country that has a tax treaty with the U.S. that exempts dividend income from taxation. See Sheppard, supra note 108, at 1314-15 (institutional investors often sell equity swaps in order to "improve equity returns or change their bets on the stock market's direction."). Either of these parties could purchase stock and then sell an equity swap on that stock for a small fee; in such a case, neither the party who really wanted the stock (i.e., the purchaser of the equity swap) nor the actual purchaser of the stock (i.e., the tax exempt party who sold the equity swap) will be subject to U.S. tax on that dividend income. Thus, the recommendations set forth in this article are designed to protect the fisc from the above transaction at the risk of taxing the same dividend declaration twice in certain nonabusive situations.

be able to structure their way out of U.S. tax simply by changing the label attached to their investments.

2. *Effect of the Straddle Rules.*—Notional principal contracts already qualify as positions in personal property.[192] Thus, equity swaps on a particular underlying property are already subject to section 1092 to the same extent as forward contracts on that same property. Therefore, the recommendations in this article will simply force the straddle rules to treat equity swaps and gold notes in the same manner.

D. *Second Best Problems*

1. *Economic Equivalencies Between a Long Forward Contract and Ownership.*—This article recommends changes to the timing, character, and source of income generated by three broad categories of financial derivatives and suggests that these recommendations also be applied to any new derivatives that are economically equivalent to the derivatives which are the subject of this article. The goal of this article is to develop interim changes to our current system with the idea that they will solve many of the tax policy problems presented by financial derivatives while at the same time providing a segue to a system in which holders of financial instruments accrue yearly the economic income generated by these instruments. These interim changes should, to the maximum extent possible, synchronize the tax treatment of economically equivalent financial instruments so that financial instruments that produce identical cash flows receive identical tax treatment.

The merit of this article's recommendations should not be evaluated from the standpoint of normative "first best" tax principles, but rather through an analysis of the trade-offs and inconsistencies that are inherent in any "second best" solution.

The theory of second best states that "if one or more constraints prevents the attainment of optimal conditions, one cannot predict in the abstract whether removing any other constraints will improve or worsen conditions."[193] If one views the Haig-Simons definition of income as the normative first best system, and thus the "optimal condition," then the recommendations in this article at most will move us closer to that optimal condition. This is because this article does not suggest that a taxpayer should accrue the economic income generated by capital assets such as stock or gold prior to the time that she disposes of that asset in a realization event. The

192. Regs. § 1.1092(d)-1(c). For a discussion of the application of the straddle rules to equity swaps, see Avi-Yonah et al., supra note 107, § 3:47.

193. Daniel N. Shaviro, Selective Limitations on Tax Benefits, 59 U. Chi. L. Rev. 1189, 1203-04 (1989) (citing R.G. Lipsey & Kelvin Lancaster, The General Theory of Second Best, 24 Rev. Econ. Stud. 11 (1956)).

article's adherence to the realization requirement stems from the reality that Congress presently will not require taxpayers to accrue income on capital assets and has therefore precluded the immediate attainment of the "optimal condition." Thus, in evaluating the recommendations in this article, the proper question is whether they "would bring an already defective system closer to the ideal."[194] In answering that question, one must, among other things, answer the related question of whether, even if the recommendations in this article do bring us closer to the ideal system, they produce more harm than good.

The recommendations in this article are admittedly second best solutions that are designed to function *within*, rather than eliminate, the current law distinctions (artificial though they may be) between debt and equity on the one hand and ordinary income and capital gain on the other. In doing so, these recommendations simply utilize the principles of current law to require purchasers of certain financial instruments to recognize for tax purposes the interest income that they are recognizing economically. For example, assume that A and B enter into a cash-settled forward contract that requires A to pay B $100 in year 2 and requires B to pay A the spot price of one share of X Co. stock in year 2. Further assume that A currently owns $85. At this point, A has incurred an obligation to pay $100 in year 2, and can satisfy that obligation in one of two ways. First, A can lend $85 to a third party and hope to earn $15 after tax over two years. Second, A can advance $85 to B and extinguish her liability to pay $100 in year 2. This article asserts that A should not be taxed differently depending on the identity of the party to whom she advances the money with which she will ultimately satisfy her obligation to pay B $100. (Perhaps the use of certain principles of current law which require taxpayers to recognize for tax purposes their economic income provides sufficient justification for the implementation of this article's recommendations.)

One could, however, easily argue that the proper paradigm of the above transaction is a direct ownership interest in X Co. stock, on which A need not accrue income under current law. That is not, however, the correct analysis. The critical difference between a direct ownership interest in X Co. stock and a cash-settled, prepaid forward contract on X Co. stock is that, in the latter case, the purchaser receives an *immediate and certain* economic benefit by virtue of the prepayment, which economic benefit results from the advance that she makes to the seller. For example, suppose that the two year forward price of one share of X Co. stock is $100, and that A pays B $85 today in exchange for such a two year forward contract. In that case, A

194. Noel B. Cunningham & Deborah H. Schenk, Colloquium on Capital Gains: The Case for a Capital Gains Preference, 48 Tax L. Rev. 319, 325 (1993).

receives a guaranteed economic benefit of $15 as a result of the advance of $85 to B, because that advance extinguished her obligation to pay $100. As discussed above, that $15 benefit is properly characterized and taxed as interest. The purchaser of a share of X Co. stock may *expect* a future benefit of $15. That benefit, however, is wholly contingent on the value of X Co. stock in two years. That contingent benefit must not be confused with the economic benefit realized by A on the prepayment of the forward contract on X Co. stock, because that latter benefit is determined solely by reference to the forward price of X Co. stock, which is *fixed*. Put differently, by coming out of pocket with $85 today, A need not come out of pocket with $100 in two years, which means that A will, in all events, receive an economic benefit of $15. In the context of our current system, where the key distinction is between debt, which connotes a fixed obligation to receive a sum certain on a given date, and equity, which connotes a wholly contingent investment of money in an enterprise, it seems logical to analyze a contractual arrangement between two parties by first determining whether that arrangement, or a component of that arrangement, is debt or equity. Having concluded, as above, that a cash-settled, prepaid forward contract contains an embedded loan, it becomes easier to justify the taxation of the interest component of that loan. In that sense, the recommendations in this article certainly move us closer to the "optimal condition."

Once one accepts the notion that the recommendations in this article accomplish what they set out to do (i.e., bring us closer to the Haig-Simons definition of income while working within our current tax regime), one must ask two more questions: First, what makes the recommendations in this article better than any of the other second best solutions, such as bifurcation, integration, and mark-to-market accounting, that have already been proposed? Second, will the recommendations in this article do more harm than good?

In responding to the first question, one must keep in mind two points: First, the recommendations in this article are easy to apply, in that they merely require the purchaser of an instrument to accrue interest income on any prepayment and to source and characterize the income from that instrument in a manner consistent with the taxation of the forward contracts to which those instruments are economically equivalent. Second, the recommendations in this article apply with equal ease to both publicly-traded and nonpublicly-traded assets.

The recommendations in this article are superior to the bifurcation approach for two reasons. The bifurcation approach would reduce a financial derivative into its component parts and then tax these components accordingly.[195] For example, the bifurcation approach would treat a gold note with

195. Weisbach, supra note 26, at 507.

NCP as a combination of a zero coupon bond that has an issue price equal to the present value of the guaranteed payment and a long call option that has a basis in the purchaser's hands equal to the difference between the issue price of the instrument and the present value assigned to the zero coupon bond. That approach is inadequate because, as discussed above, the purchaser of a gold note with NCP receives an economic benefit with respect to the entire issue price of the note and, under current law, the purchaser would not be required to accrue interest on the portion of the issue price allocated to the option premium. Thus, the bifurcation approach, in part, substitutes one tax preferred instrument (the long call option) for another. Although the recommendations in this article do not require accrual of interest on non deep-in-the-money options, they do move us closer to a system of economic accrual by classifying instruments as forward contracts to the maximum extent possible. Another reason why the bifurcation approach is inferior is that, by characterizing a portion of the gold note with NCP as a zero coupon bond, it allows taxpayers, to a certain extent, to structure their way out of the straddle rules, as zero coupon bonds are not positions in property within the meaning of section 1092.

Using a mark-to-market system to measure the gains and losses from holding capital assets at the end of each year would certainly move us much closer to the Haig-Simons definition of income. Thus far, Congress, most likely due to a combination of administrability and political concerns, has only been willing to apply that system to securities dealers[196] and holders of certain publicly traded options and futures contracts.[197] Those limitations highlight one of the key drawbacks of a mark-to-market system—it is quite difficult to value nonpublicly-traded assets each year. By requiring taxpayers to accrue income on any prepayment made in connection with an instrument properly classified as a forward contract, the recommendations in this article avoid the valuation problems inherent in a mark-to-market approach.

The integration approach requires the taxpayer and the Service to group the taxpayer's financial instrument holdings into larger units for which the tax treatment is (supposedly) settled.[198] The integration approach may work well in the case of a taxpayer who purchases a share of synthetic stock. The integration approach becomes quite difficult to apply, however, where the taxpayer's holdings do not permit the exact replication of other instruments. For example, if a taxpayer owns a two-year long call option on X Co. stock with a strike price of $135, a three-year short put option on X Co. stock with a strike price of $60, and a seven year zero coupon bond with an issue price

196. IRC § 475.
197. IRC § 1256.
198. Weisbach, supra note 26, at 526.

of $150 and a redemption price of $300, it becomes difficult for the Service and the taxpayer to integrate these three positions into a share of synthetic stock.[199]

One of the key virtues of the instant recommendations is their simplicity and ease of application. Through the mechanisms of accrual of interest and the classification of instruments, we can synchronize the tax treatment of almost all financial derivatives (non deep-in-the-money options remain the exception) and at the same time tax the interest income that accrues economically on financial instruments with respect to which the purchaser makes a prepayment.

Assuming that the recommendations in this article provide a superior and acceptable second best solution, one must determine whether they will do more harm than good. On the "good" side, these recommendations will insure, to the maximum extent possible, that economically equivalent financial instruments are taxed in the same way. Thus, they will further the goals of equity and fairness, thus moving us closer to a tax system embodying the Haig-Simons definition of income.

On the "harm" side, one must acknowledge that the above recommendations will expand the discontinuity in tax treatment between an investment in a financial derivative and a direct investment in the underlying property of that financial derivative. That is, although a cash-settled, prepaid forward contract on X Co. stock will always be the economic equivalent of a direct ownership interest in X Co. stock, a purchaser of the former instrument will be required to accrue income over the life of the investment while a purchaser of the latter instrument will enjoy the deferral of economic gain. This discontinuity will undoubtedly affect the price of either capital assets (such as shares of stock), which would under the instant recommendations be

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199. See May, supra note 25, at 1233 (full integration approach is "impossible to enforce."); see also Haskins, supra note 71, at 543 ("Although integration may seem more attractive in theory, it relies on the ability of the Service to recognize often complex financial equivalencies in taxpayers' portfolios—including 'negative' financial equivalencies that could create complex straddles—and to decide which near-equivalencies are near enough to trigger integrating rules."); Kleinbard, supra note 69, at 1361 ("Even if a generalized doctrine of tax integration of financial instruments did exist, it is by no means clear that the doctrine could be sufficiently responsive to the pace of financial innovation. The dynamism of contemporary financial strategies means that a financial position might appropriately be viewed as part of a larger synthetic unit today, and a stand-alone position tomorrow."); Strnad, supra note 141, at 574 ("Integration methods suffer from . . . ambiguities. There is more than one way to aggregate sets of instruments into groups, and the overall tax results may depend on the particular choice of groupings. In addition, the proper way to characterize a particular aggregate of instruments may not be clear in a system replete with distinct and sometimes contradictory tax approaches."); Jeff Strnad, Commentary, Taxing New Financial Products in a Second-Best World: Bifurcation and Integration, 50 Tax L. Rev. 545, 563 (1995) (analyzing problems with bifurcation and integration approaches).

tax-advantaged products, or financial derivatives, which would be tax-disadvantaged products. The precise effect of these recommendations on the stock market would be difficult to predict.[200] One could no doubt find an economist to support any possible result, and an economic analysis of the effect of accrual of income from financial derivatives on the price of stock and other capital assets is beyond the scope of this article. That does not mean that we cannot determine, from a policy standpoint, whether the recommendations in this article do more harm than good. These recommendations promote fairness, consistency, and equality in the tax system in so far as the tax treatment of economically equivalent derivatives is concerned. To the extent that unwarranted tax benefits, such as deferral of gain, may affect the price of instruments that enjoy these benefits, then the proper solution is to remove the unwarranted benefit from these instruments, regardless of the political cost of doing so. We should not let the incorrect tax treatment of certain financial instruments dictate the tax treatment of all financial instruments, particularly where the proper tax treatment of many instruments is attainable under current law principles.

In sum, the recommendations in this article would draw a line between the taxation of a financial derivative and the taxation of an ownership interest in the underlying property. To the extent that these interests may be economically equivalent to one another, one must question the appropriateness of that line. In the context of recommendations which are admittedly interim solutions designed to function in a second best world, one must accept the line between the underlying property and the derivative and then determine whether it is a good idea to tax everything on the derivative side of the line in the same way. The answer to that question is yes. With the exception of an option, each derivative discussed above mimics the cash flows generated by a cash settled forward contract. To the extent that one party to one of those derivatives advances money to her counterparty prior to the time at which her counterparty is required to make a payment, the party making the advance payment will receive compensation therefor in the form of an adjustment to the price terms of the derivative. That adjustment represents compensation for the use of money and should be taxed as interest. In keeping with our capital/ordinary distinction, the difference between the amount ultimately realized on the contract and the sum of the advance payment and the accrued interest should be treated as capital gain or loss. A system in which economically identical derivatives receive the same tax treatment and economic benefits received in return for advance payments are treated as interest increases both equality and fairness in tax treatment among

200. Cf. Calvin H. Johnson, Why is Stock so Bloody Profitable?, 75 Tax Notes 1893 (June 30, 1997).

the holders of *financial derivatives*. Until Congress overhauls the Code, however, we will be left with a potential discrepancy between the tax treatment of a derivative and the tax treatment of its underlying property. We should not, however, leave the whole system in disrepair simply because we are politically unable to fix a portion of it.

2. *And What About Prepaid Rent and Services?*—One problem with the above recommendations is that, taken to their logical conclusion, they will require purchasers of rent or services (collectively, "services") to accrue interest income whenever they make a prepayment.[201] That would lead to a serious discontinuity because, under current law, prepayments for services are treated as income to the recipient at the time of the prepayment. If that rule were applied in conjunction with the above recommendations, then an advance of money from a taxpayer to a service provider would be treated as a loan with respect to the taxpayer and income with respect to the service provider. That, to say the least, would be a unique result.

Where a taxpayer pays for services prior to the time the services are performed, the taxpayer will most likely receive a discount on the cost of these services just as the purchaser of a prepaid forward contract receives a discount on the forward price in exchange for making a prepayment. The purchaser of prepaid services should be required to account for that discount as interest income for the same reason that the purchaser of a prepaid forward contract should be required to recognize interest income. Thus, the law should be changed so that the purchaser of prepaid services is treated as making a loan to the service provider equal to the prepayment amount and then using the loan proceeds to pay for the services as the service provider earns her fee economically. The service provider should recognize ordinary income and interest expense as those items are earned or incurred economically over the life of the service agreement. In cases where the payment for services is fully deductible by the purchaser, the inclusion of interest income will be offset by the deduction of "the true forward price" of the services, which will be equal to the sum of the prepayment and the amount of interest imputed on that prepayment. Where the cost of the services is not deductible by the purchaser, e.g., an airline ticket purchased for personal use, the purchaser will be required to recognize interest income without the availability of an offsetting deduction. In the interests of simplicity and administrability, the purchaser of prepaid services should not be required to accrue interest income on the

201. After all, a prepaid contract calling for the performance of services in the future is in essence a prepaid forward contract with services as the underlying property.

prepayment amount unless the services are to be performed more than one year after the prepayment.[202]

VI. CONCLUSION

The recommendations in this article may go a long way toward resolving the discrepancies in tax treatment among gold notes, equity swaps, and cash-settled, prepaid forward contracts. These recommendations also solve many of the abuses presented by prepaid forward contracts. If applied to other instruments that are economically equivalent to forward contracts or prepaid forward contracts, then the recommendations in this article will eliminate many more discrepancies in the tax treatment of economically equivalent financial instruments. However, these recommendations represent one more plug in a hopelessly cracked dam. By plugging the hole created by prepaid forward contracts, equity swaps, and gold notes, the recommendations will only shift pressure to another point in the dam, and that point will eventually spring a leak.

The Code has long strived to treat economically identical transactions in the same way. For example, the OID rules were enacted to insure that zero coupon bonds received the same tax treatment as the fixed rate bonds to which they were equivalent economically. The OID rules cured a very simple problem. That problem concerned the disparate *timing of income* from different *debt instruments* that were economically identical.

Derivatives such as the gold note, however, give rise to discrepancies between economically identical instruments that relate to the timing, character, and source of income.[203] As long as the Code insists on drawing distinctions between equity and debt instruments and ordinary income and capital gains, these discrepancies will remain.[204] Until the Code eliminates

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202. Cf. Hal Gann & Roy Strowd, The Enormous Complexity of Being Fair, 66 Tax Notes 1711, 1711-12 (Mar. 13, 1995) ("Sometimes, when the level of precision sought by the statute fails to justify the complexity it causes, the IRS and Treasury can rebalance the two. In Treas. reg. section 1.55-1, the IRS and Treasury got some support for simplifying the individual AMT, even in a way that cost many taxpayers money."); see generally John A. Miller, Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation, 68 Wash. L. Rev. 1 (1993).

203. See Warren, supra note 66, at 461 ("[O]ur realization-based income tax has relied on a dichotomy between fixed and contingent payments that has never been completely coherent. Recent innovations in financial contracts allow taxpayers to further exploit that incoherence.").

204. See Warren, supra note 66, at 467 ("Owning a share of stock will always yield the same result as owning a zero-coupon bond, buying a call, and writing a put when the strike prices are equal to the amount due under the zero, and the exercise date of both options is also the due date of the zero. . . . At this point, the theoretical challenge presented by put-call

these distinctions, (1) issuers will continue to develop products that satisfy the tax needs of particular investors, and (2) the Service will continue to develop rules that target these products.

The only comprehensive solutions to the problems posed by derivatives involve radical changes to our current tax system. Most commentators offer five possible alternatives to our current system: (1) mark-to-market taxation of more financial instruments,[205] (2) full integration of financial instruments, (3) limitations on deductions, (4) disaggregation of financial instruments, and (5) taxation of financial contracts based on formulas that reflect the economic substance of a particular contract.[206] A discussion of the merits of those five approaches is beyond the scope of this article. It suffices to say, however, that the discrepancies in the tax treatment of different financial instruments result from tax law distinctions that the financial markets have rendered meaningless.[207] Perhaps it goes too far to suggest that the debt/equity and ordinary/capital distinctions are meaningless. After all, investors still use these distinctions to determine which financial instruments, on an after-tax basis, best suit their needs.

In the years to come, commentators will undoubtedly stress the need for significant changes in the tax treatment of derivatives. This article questions not the merit of, or need for, these proposed changes, but, rather, the ability of the government to effect these changes. Therefore, this article posits that some change is better than no change at all.

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parity to the income tax distinction between fixed and contingent returns should be apparent. If modern financial practice will permit the creation of such synthetic shares of stock, we will have two positions that yield identical results apart from taxes, but which are subject to different taxing regimes.").

205. Some commentators suggest that the expansion of mark-to-market taxation would (1) give rise to administrative burdens and (2) be limited in scope. Warren, supra note 66, at 474. In addition, the expansion of the mark-to-market system would not address the disparities in the character and source of income discussed above. Warren, supra note 66, at 474.

206. Warren, supra note 66, at 492; Strnad, supra note 141.

207. See Warren, supra note 66, at 492 ("Recent innovations in financial contracts have exacerbated the difficulties of applying the dichotomy [between fixed and contingent payments] in practice because contracts can be devised that produce substantially identical returns, but fall on opposite sides of the traditional distinction [between debt and equity]."). The development of new financial instruments has only served to further weaken the already tenuous line between debt and equity. See Hariton, supra note 92, at 1033-35 (discussing the similarities between preferred stock and debt; "[o]ne faces the enigma that, given its fixed payment schedule, preferred stock is itself a hybrid, and one that is arguably closer to debt than it is to common stock.").