

PREPAID FORWARD CONTRACT TREATED AS A SALE

Prepaid forward contracts were a popular item in the early 2000's. Such arrangements would allow the holder of substantially appreciated public stock (such as a founder whose stock had run up substantially in the bull market) to receive a payment of 75%-80% of the value of his or her shares, have an upside if the stock appreciated in value thereafter in the next few years, have no downside risk, and be able to defer income taxes on the funds paid until the transaction closed a few years later. A principal issue regarding such transactions was whether the upfront payment constituted a taxable sale in the initial year, or whether deferral existed until the transaction completely closed in a later year. Something of a sweet deal, Revenue Ruling 2003-7 allowed for nonsale treatment for prepaid forwards, at least under the facts of that ruling.

Taxpayers who participated in those transactions could typically receive a better financial deal if as part of the transaction they also lent the shares that were subject to the transaction so that the investment entity involved could sell those shares short or otherwise hedge their risks. This is what the Anschutz Company did in the prepaid forward contracts it entered into in the early 2000's.

The Tax Court has now determined that the Anschutz Company was not entitled to defer its gain, but instead had income upon entering the prepaid forward contract. The court noted that the prepaid forward, in combination with the share lending transaction, resulted in almost all incidents of ownership having been given up by the taxpayer, and thus it was appropriate to trigger gain in the year the taxpayer received the cash proceeds.

Since many of these transactions occurred awhile ago, of those older ones only those that are either under audit, in litigation, or for which the taxpayers have extended the applicable statute of limitations, will be affected by the new decision. Presumably, those whose transactions did not include the stock lending element will not be as adversely impacted by the Tax Court's analysis, but it remains to be seen how the IRS will interpret the precedential value of the case in those situations.

Anschutz Company v. Commissioner, 135 T.C. No. 5 (2010)