Tax Court Rules on Variable Prepaid Forwards and Stock Lendings

On July 22, the Tax Court published its decision in the case of *Anschutz Company v. Commissioner*, involving a taxpayer that (indirectly) engaged in various prepaid variable forward contracts (which the court calls "PVFCs") and associated stock lending agreements ("SLAs") with respect to portfolio stock (indirectly) owned by him. The court concludes that, for U.S. federal income tax purposes, upon entry into those arrangements, the taxpayer sold the shares that were the subject of the PVFCs and were lent pursuant to the SLAs.

The taxpayer, through a wholly owned S corporation,[1] entered into three PVFCs (each consisting of multiple "tranches") and SLAs with an investment bank (the "bank"). All of the relevant PVFCs and SLAs were governed by a pre-existing "master stock purchase agreement" (the "MSPA"), which required the parties, upon entry into a particular PVFC, to enter into an associated pledge agreement, pursuant to which the taxpayer would post the underlying stock as collateral and transfer it into the name of a collateral agent. The pledge agreement in turn required the collateral agent to enter into an SLA by which it agreed, as agent for the taxpayer, to lend the pledged stock to the bank upon notice from the bank. The taxpayer had the right pursuant to each SLA to recall the relevant stock by notice through the collateral agent to the bank. The court also notes that the bank had the right to accelerate the PVFCs if it "could not maintain its hedges (hedges based on [the taxpayer's] lending shares to [the bank])."

The PVFCs had 10-year terms, and upon entry the taxpayer received 80% of the value of the underlying shares (75% in the form of a prepayment, and 5% in the form of a prepaid borrow fee, a *pro rata* portion of which was required to be refunded if the taxpayer acted on his right to recall stock under the relevant SLA). The terms of the PVFCs provided that, upon their final settlement at maturity, the taxpayer would be required to deliver to the bank a number of shares of the underlying stock that varied depending on the stock's price at maturity (or in some instances, at the taxpayer's election, the cash value of that amount of stock). Through this mechanic, the taxpayer retained, economically, the ability to share in a portion of the potential appreciation in the underlying stock.

The court concludes that the taxpayer had for tax purposes sold the underlying stock that it lent to the bank upon entry into each PVFC, and was required to recognize gain equal to the difference between the cash proceeds it received at that time (*i.e.,* approximately 80% of the stock's then-fair value) and the taxpayer's basis in the underlying stock. The court's determination is based on a common law sale analysis under Section 1001;[2] in essence, it performs a 12-factor analysis (citing the Tax Court's memorandum decision in *Dunne v. Commissioner*[3]), and relies critically on its conclusions that each PVFC and its related SLA were "governed by the MSPA" and should be viewed as "related and interdependent." The court also concludes that the share lending "was a vital part of the transaction and was contemplated during the parties' negotiations."

The court rejects the argument that Section 1058 protects the share lending, on the ground that the SLA was part of the MSPA, which limited the taxpayer's risk of loss, in violation of Section 1058(b)(3). The

[1] The entity that owned the underlying stock and entered into the relevant agreements was a qualified subchapter S subsidiary of an S corporation owned by the taxpayer, Philip Anschutz. For ease of discussion, we refer to that entity as the taxpayer.

[2] Section references are to the Internal Revenue Code.

[3] T.C. Memo 2008-63.

court notes that the taxpayer's argument "might hold true if the SLAs were separate and distinct from the PVFCs. . . . However, the two are linked, and we cannot turn a blind eye to one aspect of the transaction in evaluating another. [The taxpayer] entered into one agreement that called for the lending of shares and limited its risk of loss." The court further concludes that "[t]he PVFCs and SLAs were clearly related. One could not occur without the other. To the extent that [taxpayers] argue [the parties] could have entered into the PVFCs without corresponding share-lending agreements, that hypothetical transaction is not before the Court."

The court, however, rejects the government's contention that the taxpayer should have recognized gain from these sales based on the then-fair value of the stock determined to have been sold. The government argued in essence that the gain should have been determined based on the cash prepayment(s) received from the bank (equal to 80% of the fair value of the underlying stock) plus the then-fair value of the "option" that the taxpayer essentially retained with respect to the underlying stock and its interim dividends via the variability of the forward PVFCs. The court, noting that "whether [the taxpayer] will ever receive [additional] value will not be determined until the contracts are settled," refuses to require recognition with respect to amounts in excess of the cash received.[4] The court also rejects the government's assertion (presumably expressed in the alternative) that the taxpayer had "constructively sold" under Section 1259 the underlying stock for its fair market value on the date of entry into the relevant PVFCs, either because the short sales the bank entered into to hedge its positions under the PVFCs were executed as agent for the taxpayer or because the PVFCs were "forward contracts" within the meaning of Section 1259(d)(1).

The decision will likely to do little to resolve the controversy between the government and taxpayers regarding the treatment of PVFCs entered into where the parties at a subsequent time entered into an SLA with respect to the shares underlying the PVFC. The government has taken the position that those transactions should be treated as current sales (at least upon entry into the subsequent SLA),[5] and it may be expected to claim that the *Anschutz Company* decision supports its position. On the other hand, taxpayers have relied on the separateness of the PVFC and the SLA (both in the sense of separate agreements, and in the sense of chronological separateness) to show that each agreement could occur without the other and to support the argument that entry into the SLA does not trigger a taxable sale under Section 1058(b). Based on the facts of their transactions, those taxpayers may find varying degrees of support for their reasoning in the *Anschutz Company* decision.

Each of the taxpayer and the government may choose to appeal the *Anschutz Company* decision. Even if the case is settled, there may well be further litigation on other fact patterns involving PVFCs and SLAs.

---

[4] The court leaves unanswered the question how to account for the shares taxpayer may ultimately be entitled to retain (*i.e.,* upon settlement of the PVFCs). The suggestion is that those might constitute payment in settlement of its "option," and thus perhaps might represent something in the nature of a purchase price adjustment or "earn-out," which would raise a number of uncertainties.

[5] *See, e.g.,* Tech. Adv. Mem. 200604033 (Oct. 20, 2005); Adv. Mem. 2007-004 (Jan. 24, 2007).

Please contact any of the undersigned or your regular Davis Polk tax contact if you have questions about this memorandum.

Sam Dimon	212 450 4037	sam.dimon@davispolk.com
Michael Farber	212 450 4704	michael.farber@davispolk.com
Lucy W. Farr	212 450 4026	lucy.farr@davispolk.com
Rachel D. Kleinberg	650 752 2054	rachel.kleinberg@davispolk.com
Po Sit	212 450 4571	po.sit@davispolk.com
Mario J. Verdolini	212 450 4969	mario.verdolini@davispolk.com

Any U.S. federal tax advice contained in this communication (including any attachments) is not intended to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend any transaction or matter addressed herein.

© 2010 Davis Polk & Wardwell LLP

Notice: This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you would rather not receive these memoranda, please respond to this email and indicate that you would like to be removed from our distribution list. If you have any questions about the matters covered in this publication, the names and office locations of all of our partners appear on our website, davispolk.com.