

GOING FORWARD

By Robert N. Gordon

W WALL STREET'S HEDGING TOOL OF CHOICE, THE PREPAID VARIABLE forward, is under intense scrutiny due to a Technical Advice Memorandum recently released by the IRS. TAM 200604033 comes to the conclusion that the taxpayer did exactly the opposite of what was contemplated: They triggered their capital gain.

A little history is probably appropriate here for those who are not familiar with the rules and tools used to hedge. Until 1997 the "perfect" hedge—a short against the box—was allowed. Since the passage of the "constructive sale rules" in 1997, taxpayers must retain the potential to make or lose money during the hedge so as to not flunk the rules and thus trigger gain.

In the wake of the constructive sale rules, the Treasury was supposed to issue regulations to guide investors on how much gain or loss must be retained. The rules have never been released, so advisors must rely on the legislative history and subsequent rulings to guide them in their hedging activities. We rely on the "General Explanation of the Act" issued by the Joint Committee on Taxation to give us an idea of what Congress had in mind when it passed this legislation in 1997. The constructive sale rules state that you can hedge with options to create a collar as long as that position isn't deemed abusive. Without any guidance as to what is abusive, we take comfort in an example given of an average collar that has a put equal to 95 percent of the current market price and a call that was sold giving away all appreciation above 110 percent of current market. This 15 percent band is what we use as a minimum band of upside and/or downside.

Zero-cost collars were the rage for some time. A zero-cost collar is one in which the client first chooses a floor level—say 90 percent—and buys a put, creating 90 percent protection. Then the broker finds what call must be sold to pay for that put, thus creating no cash outlay. This was quite popular, but many clients wished not just to hedge, but also to pull money out of the position. Of course, they could just borrow the bulk of the market value against the collared position, but investors borrowing more than 50 percent of a position must abide by Federal Reserve rules that restrict what those borrowed funds can be used for. Hence, the birth of the prepaid variable forward—a financial tool that is essentially a put, a call and a borrowing all "smooshed" into one contract that has no restrictions on what the money can be used for.

By reading IRS rulings and comments issued over the last eight years, one could see there were those in the government who did not love prepaid variable forwards. As an example, in 2001 the IRS issued FSA200111011 suggesting that the use of a PPVF could trigger immediate taxation of the underlying shares. That concern was somewhat eased in 2003, when the IRS issued ruling 2003-7, stating that a PPVF did not constitute a constructive sale. But shortly after the issuance of 2003-7, an IRS official commented that the ruling required a very specific set of facts and circumstances.

Then came this year's TAM. The TAM, after observing many "connections" between the hedger and the dealer, concluded that the sale of the PPVF was not respected, but instead, the client had sold their shares under common law. This point is important in that the TAM did not invoke the constructive sale rule, which was thought to be the controlling law in this area. When derivatives dealers enter into a PPVF with a client, they

don't just take on that risk; rather, they find a way to lay-off their risk. They short shares in the company underlying the PPVF. This entails the derivatives dealer taking on a cost to borrow shares to short, a risk of a short squeeze and a risk that the company may increase the dividend it has historically paid (a short seller is obligated to pay out dividends).

In the facts underlying the TAM, it seems

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that the customer was willing to accept certain conditions that, combined, caused the government to call the position a sale under common law because it was "one whole continuous transaction." The client loaned their shares to the dealer to short; the shorting price for the PPVF was the dealer's short sale price; the client was obligated to pay all dividends to the dealer, and the PPVF had to be physically settled by delivering shares (it could not be cash-settled). These and other indicia of the contract combined to cause the problem.

The debate now in the marketplace is what exactly was wrong with how the PPVF was structured. The consensus seems clear that if a client does not loan their shares to the dealer, the TAM does not apply, and the client should be safe from scrutiny.

However, it is the totality of all the facts that seemed to tip the scale, and investors need more guidance to make sure they don't tip the scale toward creating gain when their purpose is exactly the opposite.

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