Congress woke up the other day to the realization that the CAN-SPAM Act of 2003 not only hasn't stopped spam, which now accounts for 80 percent of all e-mail, but has in fact legalized it. Well, gee, didn't the legislators read the draft, which was heavily lobbied by legitimate businesses that worried that a potential advertising tool was going to be taken away? Probably not. Of course, our readers are not remotely surprised by the unintended consequences of bad drafting or ill-informed policymaking.

For readers who missed the recent viewpoint on the future of tax practice, here is what your correspondent said about derivatives in general and feline PRIDES in particular:

By separating economics from legal ownership, derivatives are turning the income tax on its head. Formal labels don't matter at all, yet the tax administration is still being run by guys who grew up on nonsensical corporate formalities. The feline PRIDES ruling is not just an isolated instance of stupidity, but prima facie evidence that these guys just don't get it. (Rev. Rul. 2003-97, 2003-34 IRB 380.) (See Tax Notes, Jan. 24, 2005, p. 474.)

In the long run, the feline PRIDES ruling is evidence, as if more were necessary, that the government does not have an overall direction for its handling of derivatives and hybrid securities. As we said in the viewpoint: "End the piecemeal response to this or that security or financial contract. This is only making the problem worse. . . . Policymakers need to step back and decide how to treat derivatives before granting any more piecemeal favors."

Dale Collinson, the special counsel to the associate chief counsel (financial institutions and products), admitted to the government's lack of direction before the New York State Bar Association (NYSBA) Tax Section on January 25. "We need a general theory of financial products," he admitted, adding that it might be necessary to bifurcate or deconstruct them.

Despite your correspondent's position against the wholesale creation of interest deductions for forward contracts and other equity-flavored securities, it is an open question whether the government should deem a debt to exist and allow an interest deduction whenever the time value of money is a factor. Some policy thinkers would deem a debt to exist in those circumstances. What is clear, however, is that no decision about the overall approach to these questions has been made, and that handling so important a question on a case-by-case basis is ill-advised and dangerous.

Yet Treasury insists on handling the questions on a case-by-case basis, even waiting for a critical mass of a particular hybrid security to be issued before considering it -- that is, blessing the tax treatment desired by the issuers and their bankers. (There may be no Wall Street Rule for retail tax shelter promoters, but there is a Wall Street Rule for Wall Street.) The piecemeal giveaways have continued, so much so that our sarcastic suggestion that the fee for a private letter ruling be raised to $20 million would be a practical and certainly proportionate response.

The latest giveaway, again for feline PRIDES, was discussed at the NYSBA meeting and at the American Bar Association Section of Taxation Financial Transactions Committee in San Diego on January 22. That would be private letter ruling 200450016, Doc 2004-23356 [PDF] or 2004 TNT 239-54, which allowed a feline PRIDES issuer to shelter gain on the repurchase of a unit under section 1032. (For those who are excitable about various investment banks' trade names, we are using the name "feline PRIDES" generically in this article.) Yet as this article will show, the proper direction for resolving section 1032 questions is not at all clear.

**Forward Contracts**

Feline PRIDES are collateralized forward contracts. The issuer's goal is to obtain an interest deduction on a deposit made by the holder and to lock the holder into a future purchase of its shares. Were feline PRIDES analyzed in their essentials, as unitary contracts, the inescapable conclusion would be that they are equity and no debt has been created. (For discussion, see Doc 2003- 12447 [PDF] or 2003 TNT 97-6.)

A corporation issues investment units consisting of a three-year forward contract to buy the corporation's common stock and a five-year note. Under the purchase contract, the holder must buy and the corporation must sell on the settlement date a variable number of the corporation's common shares. The corporation allocates the purchase price of the unit between the purchase contract and the note according to their respective fair market values, as if they were separate instruments.
The note part of the unit is pledged to secure the holder's obligation to pay the settlement price under the forward contract. The holder, however, has the legal right to separate the note from the unit by putting up new collateral for the forward contract. The issuer also promises to remarket the notes at specified intervals. In remarketing, the issuer's agent sells the note in the public market, so that the proceeds of the remarketing, and not the note itself, would be sufficient in amount to satisfy the holder's obligation under the forward contract.

In Rev. Rul. 2003-97, the IRS read section 163(l) out of the code. The IRS concluded that the interest accruing on a note portion of the unit is deductible under section 163(a), and the deduction is not disallowed under section 163(l). The IRS ruled that the note and the forward contract were separable instruments when issued, ignoring the fact that the holder would have to buy its way out of the purchase contract to separate the pieces. To find separation, the IRS was persuaded that the note would outlive the forward contract, and that the holder has creditor's rights in bankruptcy. Both of those premises are largely false. (For discussion, see Doc 2003- 18065 [PDF] or 2003 TNT 150-7.d.)

Indeed, after the revenue ruling, which was partially prospective, leaving the debt piece hanging out there seemed like a simple price to pay for the tax benefit of an interest deduction. But it turns out that leaving the debt piece out there is not so easy for issuers, even the very large issuers with good enough credit to issue hybrid securities, who visit the debt markets for hundreds of millions of dollars annually.

The debate about the separation of the components of feline PRIDES became a debate about remarketing -- so successful were advisers at steering the tax administrator away from the point. So for the second generation of feline PRIDES, advisers decided that remarketing should never be allowed to fail. That meant removing the interest rate caps provisions in the deals, meaning that remarketing would be at whatever interest rate would be necessary to clear the market and produce the desired price. Well, so what? The problem for issuers, as the following discussion will show, is that the market-clearing interest rate could be quite high.

The New Ruling

LTR 200450016, when read in conjunction with Rev. Rul. 2003-79, lets the feline PRIDES issuer have it both ways. Feline PRIDES are separate pieces when the issuer wants an interest deduction for payments on the holder's deposit. But they are unitary forward contracts on the issuer's own shares when the issuer needs to shelter a gain from buying in the debt piece under section 1032. Is this a great country, or what?

In LTR 200450016, the publicly traded company issued feline PRIDES consisting of a note and a forward contract for a variable number of its shares for a set price on a certain date in the future. The company paid quarterly interest on the note and a fee on the forward contract. The company was not deducting the fee portion. The holder could buy its way out of the forward contract by substituting collateral.

The interest on the notes was periodically reset in a process called remarketing, in which the company would offer the notes to the public at a reset rate of interest that would be sufficient to satisfy the holder's obligations under the forward contract. If remarketing failed, the holder could put the note back to the company in exchange for shares.

The value of the company's shares declined in the situation in the ruling. Why should the company care? This was obviously a second-generation feline PRIDES, with no cap on the reset rate in remarketing. So when the forward contract became worthless, remarketing would reset the interest rate on the note rather high.

Hence the company decided to redeem the notes and cancel the forward contracts, rather than remarket the notes. The company offered the holders shares and cash in exchange for the notes. The cash portion offered for the note was for accrued original issue discount. The holders, in turn, would pay cash to the company to settle the forward contracts. In practice, the cash obligations were netted, so that the holders wound up with shares.

The IRS ruled that the notes had been redeemed at their adjusted issue price and that the cash portion of the redemption constituted unpaid original issue discount, which was deductible. More important, the IRS ruled that the cash paid to the company by the holders to settle the forward contract was gain sheltered by section 1032(a). There was no discussion of those rulings. The IRS further expressed no opinion on whether the feline PRIDES were to be treated as unitary or as composed of separate notes and forward contracts.

Let's put some numbers on the ruling to show what happened. Suppose the feline PRIDES had been issued for $50 each, and that the expected exchange rate would be one of the issuer's shares per unit. Now suppose that the issuer's share price falls to $20. Our holder, having made a bet with the issuer that its share price would exceed $50, has made a losing bet, and is out $30. Our holder is not a happy camper, but neither is our issuer.

Even though our issuer is looking at being able to keep $50 in exchange for a $20 share, there's that pesky remarketing provision. The market-clearing interest rate is going to be high, and our issuer's CFO is looking at having two-year paper hanging out there some years down the road at an undesirably high interest rate. The market looks at feline PRIDES as a forward contract followed by some debt.
In our case, as in the letter ruling, the forward contract is worthless, so the issuer has an impetus to get the debt back, even at the price of excusing the holder from the forward contract. At the ABA meeting, Jeff Maddrey of PricewaterhouseCoopers and Dana Trier of Davis Polk & Wardwell noted the undesirability of having two-year debt hanging out there.

This is the practical reason why the first generation of feline PRIDES had a cap on the reset rate; issuers wanted the automatic unwind that would be provided by a failed remarketing. The debt piece of a feline PRIDES is like the old airplanes in Castle Harbour -- nice to have around for the tax benefit, but something to be shed as soon as the tax benefit goes away. Indeed, even some issuers whose share prices have appreciated have sought to get out of the debt piece. Several feline PRIDES issuers have unwound their deals by cutting deals with holders outside the provisions of the contract. Financial accountants, however, make issuers promise that they will leave the debt piece out there for the full five-year term.

So the issuer offers the holder a share and a dollar, in our numerical example, to excuse the holder from the forward contract and get the note back. In the ruling, that is, roughly speaking, what happened. Even though it is dressed up to look like an even exchange, the holder was taking a big financial hit, and the issuer had a gain by virtue of being allowed to retain part of the holder's deposit.

**Bar Discussions**

The bar association discussions focused on how a feline PRIDES issuer could elect in or out of section 1032, depending on whether it had experienced a gain or a loss in the hybrid security.

At the ABA meeting in San Diego, Linda Carlisle of White & Case noted that when the shares that are the subject of the forward contract are worth less than the agreed purchase price under the contract -- giving the contract a negative value to the holder -- then the issuer would have a gain when it received a payment from the holder to cancel the contract. That was the case in LTR 200450016. (For Carlisle's comments, see *Tax Notes*, Jan. 31, 2005, p. 591, Doc 2005-925 [PDF] or 2005 TNT 20-30.)

Had the taxpayer in the letter ruling simply delivered its shares to holders in settlement of the forward contracts, there would have been no question of having to recognize gain or loss; section 1032 would have covered it. Carlisle assumed that the taxpayer in the letter ruling did not have that option, making the question whether the cash was covered by section 1032, which does not specifically cover cash settlements of forward contracts, even after its 1984 amendment. She assumed that the taxpayer settled the forward contracts for less than the contract price.

That is, Carlisle commented, the IRS might have instead concluded that the forward contracts were settled in exchange for the taxpayer's shares, regardless of the price differential, which would clearly have been covered by section 1032. Or the IRS could have ruled that the forward contracts were futures contracts under section 1032(a), which would have sheltered the cash received by the taxpayer to cancel the contracts.

Section 1032 existed as a Treasury regulation before being ratified by Congress as a statute in 1954. The original statute covered only transactions in the issuer's shares. Since 1954, administrative interpretations and legislative amendments have broadened the reach of section 1032 to include warrants, options, futures contracts, and repurchases of options. Congress did not want corporations to recognize losses in transactions in their own shares or contracts on shares, regardless of whether settlement of the contract took the form of cash or shares. Every time Congress looked at section 1032, Maddrey noted, it has expanded the reach of the statute to prevent whipsaw.

In between the regulation and the statute, the Board of Tax Appeals held in *Illinois Rural Credit Association*, 3 B.T.A. 1178 (1926), that a forfeiture on a subscription agreement did not produce income to the corporation. When some subscribers failed to pay their installments when due, the corporation offered the subscribed shares to the public and kept the partial payments on the subscriptions. A couple of subscribers resubscribed and were credited with their previous payments. Applying an origin of the claim rationale, the BTA held that the forfeited partial payments were "capital receipts," a character not altered by failure to issue shares. Maddrey argued that the forfeited subscription price is just liquidated damages for failure to perform on the contract.

Carlisle took a narrow reading of section 1032, leaving it open for a corporation to recognize a loss in a cash transaction unwinding feline PRIDES if its shares had appreciated. She argued that *Illinois Rural Credit* would apply only to a gain, not a loss, on an unwind. Although the IRS could have reached the same result in the letter ruling by applying *Illinois Rural Credit*, she noted, it chose instead to read section 1032 expansively.

In aggressively recommending that the letter ruling leaves it open for a taxpayer to claim a loss in these circumstances, Carlisle and Geoffrey B. Lanning, also of White & Case, wrote in these pages:

The cash settlement of a forward contract to buy or sell the corporation's stock is not one of the transactions for which section 1032(a) specifically provides nonrecognition treatment and no other authority has applied section 1032(a) to such a transaction. Accordingly, a corporate taxpayer would have at least substantial authority for taking the position that section 1032(a) does not apply to the cash settlement of a forward contract on its own stock. (See *Tax Notes*, Jan. 31, 2005, p.
That position struck her fellow panelists at the ABA meeting as aggressive. Trier and Maddrey would not sign off on a loss for a taxpayer who cashed out a feline PRIDES when its shares had appreciated. Although a corporation should treat such transactions consistently, Carlisle wrote, “a corporate taxpayer that realizes a loss from its first cash settlement of a forward contract on its stock could take the position that section 1032(a) does not apply to the loss.” She insisted that the taxpayer could rely on the literal wording of section 1032, which is admittedly incomplete. “I can't believe people would take a loss in that case,” Maddrey reacted.

How is the government going to stop this? Carlisle recommended that “the IRS should issue public guidance on the application of section 1032(a) to the cash settlement of forward contracts in the form of a revenue ruling or regulations.” (Stop me before I deduct again.) Viva Hammer, an attorney-adviser in Treasury's Office of Tax Legislative Counsel, was on the ABA panel, but she didn't add anything material to the section 1032 discussion. Maddrey mused that the government may have had a policy reason to read section 1032 expansively.

At the NYSBA meeting, Collinson began his discussion of the letter ruling by saying that the corporate division, not his group, issued it. He acknowledged the incongruity between the letter ruling's treatment of the hybrids as unitary and the revenue ruling's treatment of the pieces as separate. But his view was that a broad reading of section 1032 would be for the best. The broad reading of section 1032, which says that it covers all transactions in a corporation's shares and derivatives based on them, would prevent the issuer from electing between recognition and nonrecognition depending on whether it has incurred a loss or a gain.

Other practitioners find the letter ruling to be correct and feline PRIDES unwinds to be sheltered by a broad reading of section 1032. Collinson asked rhetorically whether a forward contract should not be considered the equivalent of put and call options under section 1032. He believed that section 1032 would be invoked because the feline PRIDES was being unwound outside of the contractual terms.

Alternatively, practitioners invoke Illinois Rural Credit to fill in the gaps in section 1032. Carlisle is correct that section 1032 does not cover this situation specifically. Practitioners taking the broad view analogize the feline PRIDES forward contract to the subscription agreement at issue in Illinois Rural Credit. Trier noted that Illinois Rural Credit is near and dear to practitioners, and that his firm routinely opined based on it. But, he cautioned, the decision would not cover a derivative that only settled in cash.

Another view is that since the unwind would not have been according to the terms of the contract, there would have been an even, bargain-for-exchange. Under this reading, the issuer in our numerical example above would have an enforceable $30 claim against the holder. The holder would have bargained for a $50 share purchase, even if the shares were not worth $50 when the forward contract matured. Under this reading, the consideration offered by the issuer would have totaled $51, consisting of a $20 share, $30 forgiveness of contractual obligation, and $1 inducement fee.

What Debt?

No mention was made of cancellation of indebtedness income in LTR 200450016, and no one uttered a peep about it at either of the bar association meetings.

All of the section 1032 theories, including the government's theory in the letter ruling, treat a feline PRIDES as a single unit, rather than separate pieces of debt and forward contract. Were the security to be treated as separate pieces -- as the issuer argues to obtain an interest deduction -- wouldn't there be cancellation of indebtedness (COD) income on the unwind?

Didn't our issuer in our numerical example hand over a $20 share in satisfaction of the forward contract, pay $1 as an inducement fee, and keep $30 of the proceeds of what would have been a $50 note had the deal been allowed to run its course once the three-year forward contract expired worthless? Shouldn't the debt have been treated as worth its $50 face amount under the remarketing/reset provisions of the deal? Doesn't our issuer have $30 of COD income under section 108(e)(6), which repealed the equity-for-debt exception to COD income?

Practitioners find cases outside the bankruptcy and reorganization setting in which contracts are settled in unorthodox ways. Those cases find no debt discharge income because debt discharge is treated as a substitute for some other form of payment.

The IRS acknowledged those cases in Rev. Rul. 84-176, 1984-2 C.B. 34, in which a corporation paid off a debt to a supplier using a combination of cash and the release of a counterclaim against the supplier. The corporation had a $1,000 account payable to the supplier, but the latter had failed to ship some goods, so the corporation refused to pay. The supplier sued, and the corporation countersued. The pair settled the lawsuits, with the corporation paying $500 in cash and releasing its counterclaim in exchange for the seller releasing its claim. The corporation excluded $500 COD income under section 108(a)(1)(C).

The IRS pretended that the issuer had received $500 of damages from the supplier and then paid its $1,000 account payable in full. And the IRS concluded that the deemed receipt of the $500 -- compensation for lost profits -- would have been ordinary
income. Hence the corporation had income, but not excluded COD income. And no cash to pay the tax -- the IRS noted that money need not be exchanged for taxation to occur.

The IRS stated:

> Not every indebtedness that is cancelled results in gross income being realized by the debtor "by reason of" discharge of indebtedness within the meaning of section 108 of the Code. If a cancellation of indebtedness is simply the medium for payment of some other form of income, section 108 does not apply.

For that the IRS relied on *Spartan Petroleum v. U.S.*, 437 F. Supp. 733 (D.S.C. 1977), in which the taxpayer exchanged its rights under gasoline distribution agreements for cash and the cancellation of debt owed to the big oil company, which was agitating to cancel the distribution agreements. The big oil company would have paid the taxpayer $1.6 million in cash, then the taxpayer would have paid it $200,000 to satisfy its debt to the company. That would have been accomplished by two checks -- really -- but in the end the parties decided to net the amounts owed. So the taxpayer got $1.4 million in cash.

The debt cancellation represented one eighth of the total consideration. The taxpayer's basis in the agreements was low, so that most of the recovery represented gain to it. The taxpayer wanted to exclude the debt cancellation portion, which would have reduced its total gain by not very much. The IRS argued that the whole $1.4 million represented gain.

The court agreed on cross-motions for summary judgment. "Cancellation of indebtedness can be simply the medium through which other types of income arise," said the court, finding that the taxpayer exchanged property in the form of contract rights for total consideration of $1.6 million. The court believed that the substance of the deal overcame the form, finding that the taxpayer should be deemed to have paid its debt to the big oil company in full.

Likewise, in *OKC Corp. v. Commissioner*, 82 T.C. 638 (1984), another big oil company forgave the taxpayer's debt to it in the course of canceling a contract. The taxpayer had bought a refinery from the big oil company, which guaranteed a bank loan for the purchase price. Under contracts, the big oil company supplied crude and bought half the refinery's output, and the parties disputed the prices. The taxpayer sued to enforce the output purchase contract. The parties settled, with the big oil company agreeing to acquire and forgive the bank debt, forgiving the refinery's debt for crude, and canceling the output purchase contracts.

The taxpayer claimed that it had COD income that was excludable under section 108. The IRS argued that the debt discharge was in settlement of the taxpayer's lawsuit, so that it represented lost refining profits. The Tax Court applied an origin of the claim rationale to find that the debt discharge was settlement proceeds for damages for lost profits and a release from the expensive output contract, rather than what the judge called "pure" income from debt discharge.

Of course, the 1979 repeal of banking regulation Q occasioned an orgy of worthless debt instruments large and small. In *Colonial Savings Association v. Commissioner*, 854 F.2d 1001 (7th Cir. 1988), the Seventh Circuit considered early withdrawal penalties willingly paid by depositors on time accounts. The taxpayer, a savings bank, excluded the penalty income as COD income on the ground that the penalties represented a reduction in the debt it owed to deposit holders. (At least it was creative.) The Tax Court upheld the IRS determination that penalties were just plain old ordinary income.

Seventh Circuit Chief Judge Ripple, after staring at section 108 for a while, decided that the penalties were meant to protect the health of the bank (a real issue in those days). Of course, the penalty did arise in the course of a debt relationship, but it struck the judge as a form of liquidated damages for harm suffered from the alteration of the contractual relationship.

So where does that leave us with feline PRIDES, assuming for purposes of this discussion that the debt piece is separate? The feline PRIDES issuer has got $50 of our unhappy holder's money, and given the worthlessness of the forward contract, the deal will morph into a debt that will be repriced and hang around for a while. The OKC court put it well when it asked whether there was something else going on when the parties agreed to a debt discharge. The complication of the feline PRIDES issuer's right to put shares to the holder at an above-market price would make the debt discharge an exchange for release from the forward contract.

It also shows the dangers of paying too much attention to the form of derivatives contracts. A feline PRIDES is a collateralized forward contract followed by a debt tail that is regarded as the price of admission for an interest deduction. Had the forward contract been allowed to expire worthless in the ruling, and the issuer tried to get the debt piece back with shares and an extra buck, there would have been no question that there would have been taxable COD income. But in the ruling, the forward contract is still in place, and presumably enforceable, when the issuer goes to get the debt piece back. Only that formal aspect could save the issuer from having COD income.

**A Little Raw**

Examples that Trier furnished at the ABA meeting demonstrate corporate use of section 1032 to shelter what would have been interest income to the issuing corporation.
Suppose a corporation enters into a forward contract with the bank to purchase its own shares at a price that equals the current market price plus interest that would accrue on a loan having the same term. (The bank hedges by buying the shares.) The corporation can settle the forward contract by buying its shares for the stated price or by settling for cash (payment depending on whether shares appreciated or depreciated). Trier was not sanguine about the prospects for recognizing a loss if the corporation had to make a payment to the bank.

What if instead the bank enters into a prepaid forward share repurchase? What if the repurchase contract was for a fixed amount at a price that equals the current market price plus interest that would accrue on a loan having the same term? Maddrey analogized this to a time deposit payable in shares. Trier called this example "a little raw" and joked that Davis Polk liked to class up the deal to make the result -- the corporation not recognizing interest income -- not so obvious. (Corporations have so much cash sloshing around that they do things like this.)

"The way people who don't want to get caught" accomplish the same result, Trier joked, is by means of a collar plus a loan. The corporation pays a sum to the bank. The bank agrees that if at the end of a stated period the corporation's shares are trading within a stated range -- that would be the collar -- it will deliver a number of the corporation's shares having a value that equals the current market price plus interest that would accrue on a loan having the same term. If the share price is outside the collar range, the bank need only deliver a fixed number of shares.

The corporation and the bank are making a bet on the future value of the shares. If the share price stays within the collar, the corporation would receive the time value of its prepayment, like interest on a deposit, only it would not pay tax on that interest. If the share price falls outside of the collar, either the corporation or the bank ends up out of pocket. Trier insisted that this is not a debt because the corporation is not assured of getting its money back and has no creditor's rights. Investment bankers are marketing versions of this arrangement. Hammer found it difficult to attack when it was dressed up well.

Suppose a corporation sells shares forward at a price that reflects the current price and interest that would accrue on it. The corporation then borrows from a bank an amount equal to the proceeds of the forward sale in the form of a zero-coupon note. The corporation accrues and deducts interest on the note. Alternatively, the corporation could accomplish the same result by making a prepaid forward repurchase of the same number of shares it sold forward.

Shouldn't the corporation be accruing interest on the forward contract, since it now has cash representing the proceeds of that future sale, as though it had sold the shares under an installment contract?

The 1999 Clinton administration legislative proposal to cut back section 1032, devised by Maddrey, would have treated this transaction as an installment sale and would have taxed the corporation on the interest element. "What is the difference between an equity interest and a contract that can be satisfied in equity?" Maddrey asked rhetorically. Carlisle and Trier agreed that Trier's examples would require a legislative fix on the order of the Clinton administration proposal.

Alternatively, should the corporation's interest deduction be disallowed? David Garlock of Ernst & Young argued that this was a section 265-type arbitrage question. Some lawyers consider section 265 in opining on the deals described by Trier. (The Bush administration has, however, read section 265 out of the law. See proposed reg. section 1.265-2(c).)

The Clinton administration proposal is part and parcel of the continuing debate about whether time value should be treated separately whenever it is found as a component of a contract. The jury is still out on that; there are even policy types who wonder whether the original issue discount rules were a good idea. (For discussion, see Weisbach, "A Partial Mark-to-Market Tax System," 53 Tax L. Rev. 95 (1999).)

The Clinton administration did not propose recognizing time value in every derivative relating to a corporation's own shares. Rather, the Clinton Treasury merely proposed that time value be treated separately on forward sales of a corporation's own shares. The corporation would have been required to recognize either original issue discount or interest on an installment sale, but the holder would not have had a deduction. Analogous to section 1258, the proposal would have treated the forward price as a corporate asset before settlement of the contract in shares. (Department of the Treasury, "General Explanation of the Administration's Revenue Proposals," Doc 1999-4614 or 1999 TNT 21-36.)

The proposal was very narrow because the Clinton administration had in mind private deals between corporations and investment banks that were basically section 1032 abuses intended to create interest deductions. The corporation borrows, uses the proceeds to buy its own shares, then enters into a prepaid forward sale of those shares with its friendly investment banker, using the proceeds of the forward sale to defease the debt, which remains outstanding so that the corporation can continue to deduct interest. The transaction was labeled a corporate tax shelter. (See Doc 1999-5359 or 1999 TNT 25-4.)

The NYSBA Tax Section has long advocated a broad reading of section 1032. In its 1999 report on section 1032, the NYSBA slugged the Clinton administration proposal while recommending that section 1032 be expanded to cover transactions that are economically equivalent of those already covered. Economic equivalents would include derivatives related to a corporation's own shares, even if those contracts settled in cash. The NYSBA defined equivalents as "any other contract or position to the extent it provides for payments calculated . . . by reference to the value of such corporation's stock." So equity swaps and cash-settled
Forward contracts would be covered. (For the NYSBA report, see Doc 1999-21422 or 1999 TNT 119-22.)

**Where to Now?**

Expansion of section 1032 has basically created a tax shelter for companies making bets with investors on the value of their shares.

The NYSBA report noted that section 1032 could be limited to its "core" element; that is, transactions in which a corporation issues or purchases its own shares for fair market value at the time of settlement of the contract. That would mean that a corporation would recognize gain or loss if a contract on its shares settled in cash. It would also mean that a corporation would have to recognize an interest element when a contract on its shares settled for more than fair market value of those shares, as in Trier's examples. The NYSBA objected that the economic equivalence of a derivative to a share argues for treating the two should be treated alike. And restriction of section 1032 to core transactions would, uh, "destabilize the tax system."

Alternatively, section 1032 could be restricted to contracts that can be physically settled only in the corporation's shares. Then the question would be, as in the feline PRIDES case, whether section 1032 should apply when the parties agreed to a cash settlement outside the terms of the contract. In recommending its all-encompassing approach instead, the NYSBA admitted that it "would not tax corporations on their economic gain; corporations that 'win' derivative bets on their own stock would not be taxed, and corporations that 'lose' derivative bets on their own stock would not be allowed to take those losses into account."

In a paper prepared for the December 2003 University of Chicago Tax Conference, Prof. Alvin C. Warren of Harvard Law School amply demonstrated the shelter provided by section 1032 for corporate gambling in the issuer's own shares, especially in the case of employee compensatory options. Warren advocated limiting section 1032 to what the NYSBA would call the core transaction -- the issuance or repurchase of shares at fair market value. Otherwise, a corporation should have to recognize capital gain or loss on transactions in its own shares. (Warren, "Taxation of Options on the Issuer's Stock," *Taxes*, March 2004, p. 51.)

Michael Schler of Cravath Swaine & Moore, a longtime advocate of a very broad reading of section 1032, responded to Warren's argument. He saw a stark choice as between broadening or narrowing section 1032. Schler's preferred approach would be an extreme broadening that would shelter "any economic gain or loss attributable to a change in value" of a corporation's shares. He viewed a broadening as a logical extension of the 1984 extension of section 1032 to lapsed options, while admitting that the latter makes a theoretically appealing case for narrowing section 1032. He further admitted that his broad approach would raise bifurcation questions, especially with convertibles. (Schler, "Deconstructing Code Section 1032: An Analysis and Commentary," *Taxes*, March 2004, p. 173.)

Schler and Warren agreed that there is no principled basis for the exclusion and inclusion of certain transactions in the present section 1032. Schler noted that despite the theoretical correctness of Warren's narrow approach, it would not resolve the question of a corporation dealing in contracts on its own shares when it was fully hedged against the risks. Nor would either approach cure the time value problem described by Trier. Schler's big argument for the broad version was the same as Collinson's -- it would eliminate taxpayer election to recognize losses on contracts on its own shares.

Without section 1032, there is an imbalance in the system. Trier agreed with Columbia Law School Dean David Schizer that a broad section 1032 is necessary to prevent selective recognition of losses by taxpayers. In a recent article, Schizer argued that the problem with section 1032 is the uncertainty about whether it applies to derivatives. Clarification, he argued, ought to be the first priority. Schizer noted that the time value problems identified by Trier would have to be addressed separately. The combination of broadening and a time value rule, he concluded, would rid the system of most of the problems. (Schizer, "Balance in the Taxation of Derivative Securities: An Agenda for Reform," 104 *Columbia L. Rev.* 1886 (2004), http://www.columbialawreview.org/pdf/Schizer-Web.pdf.)