

TABLE OF CONTENTS

<u>CHAIRPERSON'S LETTER TO TAXATION SECTION MEMBERS</u>	2
<u>REPORTS FROM THE COMMITTEES</u>	
Business Entities Committee	4
Employee Benefits Committee	4
Estates and Trusts Committee	4
Practice and Procedure Committee	5
State and Local Tax Committee	6
<u>FEATURE ARTICLES</u>	
Working Within the Final Split-Dollar Life Insurance Regulations By: Robert M. Hartley	9
IRS Treats Obligation to Deliver Securities (and/or Cash) Under Variable Prepaid Forward Contract as Partnership Liability – But Proceed with Caution! By: James H. Combs and Alexander G. Domenicucci	17
<u>SHORT SUBJECTS</u>	
Is Bonus Depreciation the Death of the 1031 Exchange? By: Don Katz and Paul McCord	29
Harry Potter and the Incredible Irrevocable Insurance Trust By: Dennis M. Mitzel	33
<u>STATE AND LOCAL TAX UPDATE</u>	
Michigan Court of Appeals Upholds Successor Liability Tax Assessment By: Jennifer Troyer of KPMG LLP	36
<u>SECTION NEWS</u>	
Seventeenth Annual Summer Tax Conference Report	40

IRS Treats Obligation to Deliver Securities (and/or Cash) Under Variable Prepaid Forward Contract as Partnership Liability – But Proceed with Caution!

By: James H. Combs and
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The Internal Revenue Service (“*IRS*”) recently released Technical Advice Memorandum (“*TAM*”) 200341005 (October 10, 2003), which addresses the federal income taxation of a prepaid forward sale of a variable amount of stock. Earlier in 2003, the IRS had published a revenue ruling, Revenue Ruling 2003-7,¹ that concluded that execution of one type of “variable prepaid forward contract” (“*VPFC*”), an “over-the-counter” VPFC, did not result in a current IRC § 1001 sale or exchange of the underlying stock. TAM 200341005 applies the reasoning of Revenue Ruling 2003-7 to an alternative structure for a VPFC transaction, a “trust structure” VPFC, and reaches the same conclusion on the common law sale issue.

TAM 200341005 also analyzes the potential interaction of certain partnership taxation rules, in particular the disguised sale rules of IRC § 707, with the taxation of VPFC transactions. The disguised sale rules potentially can play a significant role in VPFC transactions where the taxpayer holds stock through a family limited partnership. In this area, the TAM appears to break new ground, concluding that an obligation to deliver securities and/or cash under a VPFC is a “liability” under IRC § 752. This taxpayer-friendly result is significant because the Department of Treasury recently proposed regulations (which are to be effective as of June 24, 2003, if finalized) that administratively reach the same result as TAM 200341005. TAM 200341005 addresses a taxable year prior to the publication (and potential effective date) of the pro-

posed regulations, suggesting that the TAM represents the IRS’ settled view on the state of the law prior to June 24, 2003. However, the IRS’ analysis of the liability issue in the TAM is incomplete and somewhat misleading, which raises questions about the position taken in the TAM and the proposed regulations. This article first reviews the facts of the TAM and the IRS’ analysis of whether entry into the transaction resulted in a common law sale, and then looks at the IRS’ analysis of the partnership taxation issues raised by the structure of the transaction.

Facts of TAM 200341005

In TAM 200341005, an individual owned 100% of an entity (“*Shareholder*”) that held shares of Corporation A. For accounting reasons, the Shareholder desired to reduce the percentage ownership of Corporation A shares that it held directly. In order to achieve this goal, the Shareholder undertook the following steps:

- The Shareholder contributed shares of Corporation A stock to a partnership (“*Partnership*”) in exchange for a non-managing membership interest and distributions of cash. The contributions occurred on two dates: the “Execution Date” and the “Option Date.”
- The Partnership established a trust comprised of two sub-trusts: Series A Sub Trust and Financial Instruments Sub Trust.
- In exchange for interests in Series A Sub Trust, the Partnership contributed shares of Corporation A stock. The

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interests in the Series A Sub Trust provided the Partnership a beneficial interest in the Corporation A shares, including the power to vote the shares through the trust, to receive ordinary dividends on the shares and to receive the proceeds of a sale, exchange or liquidation of the shares.

- The Series A Sub Trust and the Financial Instruments Sub Trust entered into an agreement (the "**Trust Obligation**") whereby the Series A Sub Trust agreed to deliver to Financial Instruments Sub Trust, on a date in the future, shares of Corporation A stock, cash or a combination thereof.
- The Trust Obligation required the Series A Sub Trust to deliver to investors (described below) in Financial Instruments Sub Trust a number of shares (or equivalent value of cash or cash and shares) determined under the "Exchange Formula." The Exchange Formula provided that the amount of stock (or cash or combination of stock and cash) to be delivered to settle the contract would depend on the trading price of the shares at settlement.
- The Financial Instruments Sub Trust sold "Financial Instruments" at a discount to an underwriting syndicate made up of several brokers who acted as initial purchasers of the Financial Instruments. These sales occurred on each of the Execution Date and the Option Date.
- The underwriting syndicate sold the Financial Instruments to third party investors for their "full value." The Financial Instruments Sub Trust applied the proceeds to purchase

Treasury securities, compensate a trustee and to pay the Series A Sub Trust under the Trust Obligation. The Financial Instruments entitled the holders to a beneficial interest in the Trust Obligation and in the Treasury securities. The Treasury securities had staggered maturities that funded quarterly distributions to the holders of the Financial Instruments.

- The Trust's ability to exercise the cash settlement option was controlled by the Shareholder through the Partnership, which held the Series A Sub Trust interest. As of the Execution Date, the Shareholder was restricted in its ability to exercise the cash settlement option to the extent that such exercise and the subsequent liquidation of the Partnership would result in the Shareholder owning more than a specified percentage of Corporation A.
- The Trust Obligation contained various other features relating to price adjustments upon certain events and to distributions including stock splits or stock dividends, and permitting the early settlement or partial liquidation of the Financial Instruments under limited circumstances.
- On the Execution Date and the Option Date, the Series A Sub Trust distributed the funds that it received to the Partnership, which used a portion of the funds to acquire Treasury securities and the balance to distribute to the Shareholder.

Common Law Sale Analysis

The first issue addressed in TAM 200341005 was whether the Shareholder's execution of the VPFC through the Partnership

and the trusts resulted in a common law sale of the Corporation A shares sold forward under IRC § 1001.² VPFCs resemble current sales of stock because the taxpayer relinquishes title to and possession of securities and receives a payment of cash in the transaction. However, the common law taxation of forward contracts and other authorities addressing the tax ownership of securities support holding a forward sale open until shares are actually delivered to the forward purchaser to settle the contract where the taxpayer retains certain rights in respect of the securities.³

There are two formats typically adopted for VPFC transactions: an over-the-counter derivative and the trust structure.⁴ The over-the-counter VPFC is used for smaller positions in a stock and a financial institution acts as the forward purchaser under the contract. The financial institution hedges its risk under the VPFC by entering into offsetting trades (e.g., short sales of the same security).⁵ For larger positions in a stock, the financial institution may find it difficult to lay off its risk because there may not be sufficient shares available for the stock loans necessary for the financial institution to enter into offsetting short sales.⁶ In this situation, the parties generally employ the "trust structure" VPFC described in TAM 200341005. In a trust structure VPFC, the financial institution acts as an underwriter (rather than as the counterparty) and locates investors willing to enter into the forward purchase side of the VPFC.⁷ The trust structure VPFC is a more complicated form of a prepaid forward sale of a variable amount of stock than an over-the-counter VPFC transaction. In substance, however, the forward contract component of the two transactions is essentially the same.

The IRS has ruled that entry into an over-the-counter VPFC transac-

tion does not result in a current sale of the underlying stock.⁸ In Revenue Ruling 2003-7, the taxpayer, an individual, entered into an agreement to deliver a variable amount of stock in a publicly-traded corporation to an investment bank counterparty on a date three years in the future. In exchange for this future delivery obligation, the taxpayer received an up-front payment of cash.⁹ The taxpayer secured his obligation by pledging the maximum number of shares potentially deliverable under the contract to a third party trust unrelated to the investment bank. Under the declaration of trust, the taxpayer retained the right to vote the shares and to receive dividends. The taxpayer also had the right to deliver the equivalent value of cash or other shares (or a combination of cash and other shares) at settlement. On the execution date of the VPFC, the taxpayer intended to deliver the pledged shares to settle the contract.

Revenue Ruling 2003-7 held that entry into this over-the-counter VPFC does not cause a sale of the stock to the forward purchaser upon execution of the contract. This holding was based on cases involving the transfer of securities to brokerage firms pursuant to subordination agreements and cases involving short sales of securities. The IRS cited the subordination agreement cases as authority for the proposition that a taxpayer can transfer title and possession of securities to another party without relinquishing tax ownership, so long as the taxpayer retains the right to vote the shares, to receive dividends and to reacquire the shares (e.g., by substituting other collateral).¹⁰ The IRS cited the short sale cases for the proposition that the delivery of shares is the operative event that closes the sale for tax purposes; a taxpayer's intent to deliver particular shares does not control the completion of the sale if the taxpayer has the right to determine whether

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particular shares will in fact be delivered.¹¹

The IRS also distinguished the VPFC transaction in Revenue Ruling 2003-7 from the conveyance of securities in *Hope v. Commissioner*.¹² In the *Hope* case, the taxpayer argued that a sale of securities to an investment bank had not been completed because the taxpayer sought rescission of the sale contract. The court rejected this argument because the taxpayer had transferred the shares to the investment bank and received cash without any restrictions on use or disposition. Although the taxpayer in Revenue Ruling 2003-7 also transferred shares and received cash not subject to any restrictions, the IRS noted that the transfer was to a third party trust that was unrelated to the investment bank. While the revenue ruling may be read to suggest that a third party trust as collateral agent is a necessary element for avoiding a current sale, the IRS distinguished the *Hope* case on other grounds as well (the taxpayer's retention of voting rights and dividends) and it appears that the use of such a trust is not mandatory to avoid a sale.¹³

In addition to the principles derived from the cited cases, Revenue Ruling 2003-7 also introduced two considerations asserted by the IRS to be potentially relevant to the analysis of whether a sale occurs upon execution of a VPFC. These factors are whether the taxpayer is under an "economic compulsion" or is restricted by "any legal restraint or requirement" to settle the contract with the pledged shares rather than cash or other shares.¹⁴ The IRS stated as an example that a restriction on the taxpayer's ability to own the pledged shares after the settlement date would be a "significant" factor in the determination of whether a sale had occurred.¹⁵ The revenue ruling did not specify when a taxpayer is required to test for the presence of economic compulsion

or the absence of an unrestricted legal right to deliver cash or shares other than the pledged shares.¹⁶

TAM 200341005 applies the reasoning of Revenue Ruling 2003-7 to a trust structure VPFC transaction. The IRS explicitly acknowledged the similarity between over-the-counter VPFCs and trust structure VPFCs in TAM 200341005, listing off the elements common to both transactions. The IRS did not attempt to draw any distinctions from Revenue Ruling 2003-7 based on the sale of the securities through the trust, and the bulk of the IRS' sale analysis in the TAM focused on the unrestricted legal rights factor introduced in Revenue Ruling 2003-7.¹⁷

The TAM devoted several paragraphs to the determination of whether the Shareholder had, through the Partnership, a right "unrestricted by agreement or economic circumstances" to deliver property other than the pledged shares. This issue arose because, as of the Execution Date, the Shareholder could not by agreement own more than a certain percentage of the shares of Corporation A on the settlement date. The IRS noted that this agreement limited the Shareholder's ability to cause the Partnership to exercise the cash settlement option and to reacquire the pledged shares. However, the IRS accorded little weight to this restriction because Corporation A sold additional stock on the day following the Execution Date, which diluted Shareholders' percentage ownership of Corporation A. This stock offering negated any limitation on the Shareholder's ability to cause the Partnership to cash settle the VPFC. According to the IRS, the Shareholder, through the Partnership, did "effectively" have an unrestricted legal right to cash settle the contract.¹⁸ The focus of the TAM on the existence or absence of an unrestricted legal right as of the

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Execution Date thus appears to establish that the proper time to test for this factor is on the date the taxpayer enters into the contract.

Based on the similarity of the facts of TAM 200341005 to Revenue Ruling 2003-7 and the “effective” unrestricted legal right to reacquire the pledged shares, the IRS concluded that (i) the Shareholder’s transfer of Corporation A shares to the trust, through the Partnership, did not constitute a taxable sale or exchange of the shares from the Shareholder to the Financial Instrument investors and (ii) the investors’ acquisition of the Financial Instruments also did not constitute a taxable sale or exchange of the Corporation A shares. Therefore, TAM 200341005 confirms that the interposition of a trust to facilitate the forward sale of securities in a VPFC transaction and the sale of interests in that trust does not alter the common law sale analysis employed in Revenue Ruling 2003-7. Having reached this conclusion, the IRS next turned to analysis of the partnership taxation issues.

The Trust Obligation as a Partnership Liability

The taxpayer in TAM 200341005 used a partnership as a vehicle to implement the trust structure VPFC transaction, with the contributions of Corporation A stock to the Partnership constituting a part of the overall transaction. The use of a partnership may also arise in connection with a trust structure VPFC in slightly different contexts, for example, where a taxpayer previously contributed appreciated stock to a family limited partnership for estate planning and liability protection purposes and is now seeking to lock in gain attributable to the stock while deferring recognition of the gain. Critical to whether a trust structure VPFC is viable when a partnership is involved is whether the forward seller’s obligation to deliver securities and/or

cash under the VPFC is a liability for purposes of IRC § 752.¹⁹

IRC § 752 applies to determine a partner’s share of partnership liabilities. Under IRC § 752, a partner is deemed to have made a contribution of money to the partnership to the extent his share of partnership liabilities increases.²⁰ On the other hand, a partner is deemed to have received a distribution of cash to the extent his share of partnership liabilities decreases.²¹ A deemed contribution increases the partner’s basis in his partnership interest and a deemed distribution decreases (but not below zero) the partner’s basis in his partnership interest.²² Thus, if a forward seller’s obligation to deliver securities and/or cash under a VPFC is a liability for purposes of IRC § 752, then the distribution of the proceeds from the VPFC to the partners is generally not taxable to them because there is sufficient basis in their partnership interests to absorb the distribution.²³

In TAM 200341005, the liability issue was also important because of the potential application of the disguised sale rules of IRC § 707. Under the disguised sale rules, a contribution of property to a partnership followed shortly by a distribution of cash by the partnership to the contributing partner is generally treated as a taxable sale by the partner to the partnership of an interest in the property.²⁴ A disguised sale is presumed if the distribution to the partner occurs within 2 years of the contribution by the partner of property to the partnership.²⁵ There are a number of exceptions to the disguised sale rules, one of which applies where the cash distributed to the contributing partner is from proceeds of a liability incurred within 90 days of the distribution, but only to the extent of the partner’s allocable share of such liability.²⁶

For this purpose, a partner’s allocable share of a liability equals

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the partner's share of the liability multiplied by a fraction (i) the numerator of which is the portion of the liability allocable to the distribution made to the partner and (ii) the denominator of which is the total amount of the liability.²⁷ The determination of a partner's share of a liability of a partnership depends on whether the debt is recourse or nonrecourse. If recourse, the liability is allocated among the partners in the amounts for which they would bear personal liability if the partnership's assets were to become worthless.²⁸ If non-recourse, the liability is generally allocated among the partners in the same proportions in which they share profits.²⁹

In TAM 200341005, the IRS ruled that the Trust Obligation was a non-recourse liability under IRC § 752. The IRS also ruled that the distributions of cash were from the proceeds of the Trust Obligation and such distributions did not exceed the Shareholder's allocable share of the Trust Obligation.³⁰ Accordingly, because the distributions to the Shareholder of cash were made within 90 days of the Partnership incurring the Trust Obligation, the IRS concluded that the simultaneous contributions of Corporation A stock by, and distributions of cash to, the Shareholder were not disguised sales.

During the period at issue in TAM 200341005, there was neither a statutory nor regulatory definition of liability for purposes of IRC § 752.³¹ In TAM 200341005, the IRS relied on two revenue rulings to reach its conclusion that the Trust Obligation was a liability for purposes of IRC § 752. The first, Revenue Ruling 88-77,³² addressed whether the accrued expenses and accounts payable of a cash basis partnership were liabilities for purposes of IRC § 752. The IRS explained that a partnership liability for purposes of IRC § 752 includes an obligation only if and to the extent that incurring the liability:

- (i) creates or increases the basis to the partnership of any of the partnership's assets (including cash attributable to borrowings),
- (ii) gives rise to an immediate deduction to the partnership,
- (iii) or, under IRC § 705(a)(2)(B), currently decreases a partner's basis in the partner's partnership interest.³³

Under this definition of liability, the IRS ruled that the accrued expenses and accounts payable were not partnership liabilities because they did not increase the basis of the partnership's assets or give rise to a deduction.³⁴

The second revenue ruling relied on by the IRS to conclude that the Trust Obligation was a liability for purposes of IRC § 752 was Revenue Ruling 95-26.³⁵ The ruling involved a partnership that entered into a short sale of securities. The short sale was effectuated by the partnership's broker, which loaned securities that it had on hand to the partnership and then sold them on the partnership's behalf. The partnership was obligated to return identical securities to close out the short sale. The IRS, relying principally on Revenue Ruling 88-77, ruled that the short sale created a partnership liability under IRC § 752 because the partnership had an obligation to return the borrowed securities, and the cash received in the short sale increased the basis of the partnership's assets.

While the IRS discussed Revenue Rulings 88-77 and 95-26 in TAM 200341005, it did not discuss other authorities bearing on the issue of whether the Trust Obligation is a liability for purposes of IRC § 752. For starters, the IRS did not discuss Revenue Ruling 73-301,³⁶ where the IRS ruled that progress payments under a construction contract made to a partnership using the completed contract method of accounting did not

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give rise to a liability for purposes of IRC § 752. In the ruling, the partnership, which was engaged in the construction business, reported income received under a 2-year construction contract on the completed contract method of accounting. Under the contract, the partnership received progress payments during 1971 that it was not required to report under its method of accounting. The IRS ruled that the 1971 progress payments were “unrealized receivables” that did not give rise to a liability under IRC § 752.

The IRS’ holding in Revenue Ruling 73-301 is arguably inconsistent with its definition of liability in Revenue Ruling 88-77. The partnership’s obligation in Revenue Ruling 73-301 to perform services under the construction contract appears to be a liability under the definition in Revenue Ruling 88-77 because the progress payments increased the basis of the partnership’s assets.³⁷

The IRS in TAM 200341005 also failed to mention *Helmer v. Commissioner*,³⁸ where the Tax Court decided that a partnership’s receipt of an option premium, and its attendant obligation to credit the premium against the purchase price of the underlying property if the optionee exercised the option, did not give rise to a liability for purposes of IRC § 752. In *Helmer*, the partnership entered into an agreement under which the optionee had the option to purchase certain real estate. Under the agreement, the optionee was obligated to make an initial payment to the partnership and annual payments thereafter in consideration for the option. The partners of the partnership argued that the option premium created a liability under IRC § 752 and, accordingly, increased the basis in their partnership interests. The court, in rejecting the partners’ argument, held that the partnership had no liability under the option

agreement for purposes of IRC § 752. The court explained that the partnership was neither required to repay the option premium in the event the optionee allowed the option to lapse nor perform any services in the future. According to the court, the partnership’s only obligation was to apply the option premium against the purchase price should the optionee exercise the option.

The *Helmer* decision seemingly conflicts with the IRS’ definition of liability in Revenue Ruling 88-77. The partnership’s obligation to apply the option premium against the purchase price of the real estate in the event of the option’s exercise appears to be a liability under the definition in Revenue Ruling 88-77 because the option premium increased the partnership’s basis in its assets. Perhaps one might argue that *Helmer* and Revenue Ruling 88-77 may be reconciled on the basis that contingent obligations should be treated differently for purposes of IRC § 752.³⁹ There are, however, at least two potential problems with such an argument. First, the definition of liability in Revenue Ruling 88-77 does not purport to make a distinction between fixed and contingent liabilities. Second, there is arguably no sound policy reason for treating contingent liabilities differently in this context.⁴⁰

Another court decision the IRS failed to discuss in TAM 200341005 is *Salina Partnership LP, FPL Group, Inc. v. Commissioner*,⁴¹ a case which arguably supports the IRS’ conclusion. In *Salina*, the taxpayer, which had substantial capital losses, became a partner in a newly formed limited partnership. The partnership then immediately liquidated its position in a short sale of U.S. Treasury bills, with the taxpayer reporting a capital gain from the transaction. Relying principally on Revenue Ruling 88-77, the IRS argued that

The Helmer decision seemingly conflicts with the IRS’ definition of liability in Revenue Ruling 88-77.

While TAM 200341005 provides some comfort to taxpayers that have entered into, or are considering entering into, a VPFC involving a partnership, there is sufficient authority for the IRS to reverse course and to treat a forward seller's obligation to deliver securities and/or cash under a VPFC as something other than a liability for purposes of IRC § 752.

the obligation to return the borrowed securities under the short sale was a liability for purposes of IRC § 752, with the consequence that the reported capital gain was virtually eliminated.⁴² The taxpayer, relying on Revenue Ruling 73-301 and *Helmer* among other authorities, argued that there was no liability for purposes of IRC § 752.

The court rejected the taxpayer's argument that there was no liability under IRC § 752. The court reasoned that Revenue Ruling 73-301 and *Helmer* recognize that there are cases in which a taxpayer's obligation under an open transaction is a liability for purposes of IRC § 752. The court then concluded that a short seller's obligation to return borrowed securities is such an obligation.⁴³ The court, however, failed to adequately explain why a short seller's obligation to return borrowed securities should be treated differently than the obligations in Revenue Ruling 73-301 and *Helmer*. The court did not attempt to distinguish the taxpayer's obligation in Revenue Ruling 73-301. As for the taxpayer's obligation in *Helmer*, the court attempted to distinguish it on the basis that the option premium in *Helmer* "represented fixed payments on the sale of a partnership asset that were free and clear of any claim for repayment or demand for further services." The court did not recognize and address the fact that, under any characterization, the taxpayer in *Helmer* had a contingent obligation (*i.e.*, the obligation to apply the option premium against the purchase price of the real estate in the event of the option's exercise).

In short, the holdings in Revenue Ruling 73-301 and *Helmer* arguably undermine Revenue Rulings 88-77 and 95-26. While TAM 200341005 provides some comfort to taxpayers that have entered into, or are considering entering into, a VPFC involving a partnership, there is sufficient

authority for the IRS to reverse course and to treat a forward seller's obligation to deliver securities and/or cash under a VPFC as something other than a liability for purposes of IRC § 752. Taxpayers should be careful not to take too much comfort from TAM 200341005.

Recently Proposed Treasury Regulations

In June of 2003, after the period at issue in TAM 200341005, the IRS issued proposed regulations defining liability for purposes of IRC § 752, applicable to liabilities incurred or assumed by a partnership after June 23, 2003. The proposed regulations provide that an obligation is a liability for purposes of IRC § 752 only if and to the extent that incurring the obligation:

- (i) creates or increases the basis of any of the obligor's assets (including cash),
- (ii) gives rise to an immediate deduction to the obligor, or
- (iii) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.⁴⁴

In addition, the proposed regulations provide that an obligation is any fixed or contingent obligation to make payment (without regard to whether it is otherwise taken into account for other federal tax purposes), including debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative instruments such as options, forward contracts and futures contracts. Therefore, under the proposed regulations, an obligation to deliver securities and/or cash under a VPFC is a liability for purposes of IRC § 752. The preamble to the proposed regulations explicitly states that

the regulations do not follow the *Helmer* decision.⁴⁵

Notwithstanding that under the proposed regulations an obligation to deliver securities and/or cash under a VPFC is a liability, taxpayers should still use caution in structuring VPFCs involving a partnership. While proposed regulations can be used to avoid the substantial understatement of tax penalty⁴⁶ and the tax return preparer penalty,⁴⁷ the weight given to proposed regulations for other purposes (*e.g.*, determining the merits of a case) is unclear. The IRS has recently stated that it generally will not take a position in litigation inconsistent with a position in proposed regulations.⁴⁸ The IRS has warned, however, that proposed regulations may not be relied upon for planning purposes unless they explicitly state they may so be relied upon.⁴⁹ Therefore, if proposed regulations do not state that they may be relied upon, taxpayers planning their affairs based on such regulations are at risk that they might change by the time of any resulting litigation. Unfortunately for taxpayers, the new proposed regulations defining liability for purposes of IRC § 752 do not state that taxpayers may rely on them for planning purposes.

Conclusion

The issuance of TAM 200341005 is a positive development for taxpayers that have entered into, or are considering entering into, a VPFC, especially those transactions where the shares are held by a partnership that intends to distribute the sale proceeds. The TAM first confirms that taxation of a VPFC using a trust structure will not vary from the taxation of the over-the-counter VPFC analyzed in Revenue Ruling 2003-7. In addition, the TAM posits that an obligation to deliver securities and/or cash under a VPFC is a

liability for purposes of IRC § 752. On this point, however, taxpayers considering entering into a VPFC involving a partnership should proceed with caution because Revenue Ruling 73-301 and *Helmer* arguably conflict with the authorities underlying TAM 200341005 and the proposed regulations.

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... the weight given to proposed regulations for other purposes ... is unclear.

ENDNOTES

1. 2003-5 I.R.B. 363.
2. The facts do not indicate whether the shares of Corporation A stock held by the Partnership were appreciated on the Execution Date or the Option Date. TAM 200341005 does not discuss the constructive sale rules of IRC § 1259, although the "Law and Analysis" section of the TAM states that the number of shares potentially deliverable under the Exchange Formula "varies significantly." This suggests that IRC § 1259(c)(1)(C), which requires the recognition of gain upon entry into a "forward contract" with respect to an appreciated financial position, is not an issue. A "forward contract" is defined in IRC § 1259(d)(1) as a contract calling for future delivery of a "substantially fixed" amount of property (including cash) for a "substantially fixed" price. The amount of property is not "substantially fixed" if there is a "significant variation." S. Rep. No. 105-33, 105th Cong. 1st Sess., (1997) at 125-126; Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997," (JCS-23-97) at 178. Revenue Ruling 2003-7 provides that a 20% variation in shares is significant and that a VPFC with such variation is not a forward contract. It should also be noted that the Treasury Department has authority to issue regulations under IRC § 1259(c)(1)(E) to address financial transactions, such as option collars, that have "substantially the same effect" as the constructive sale transactions listed in IRC § 1259(c)(1)(A)-(D). This provision is potentially relevant to VPFC transactions, which are economically similar to option collars. See David H. Shapiro, Taxpayer-Friendly Result in Rev. Rul. 2003-7 May Create a False Sense of Security, 98 Tax Notes 1265 (February 24, 2003) (stating that it appears that taxpayers can assume that the VPFC described in Revenue Ruling 2003-7 is not equivalent to an "abusive" option collar that Treasury may target retroactively in regulations to be issued under IRC § 1259(c)(1)(E)). It has been reported that Treasury recently withdrew IRC § 1259 from its 2003-2004 guidance plan. See Lee A. Sheppard, ABA Meeting Ponders Tax Shelters and Financial Transactions, 100 Tax Notes 1490 (September 22, 2003).
3. See Robert A. Rudnick and Michelle L. Petock, Forward Sale Contracts: The IRS's Recent Attempts to View Code Sec. 1259 As a Trap for the Wary, 3 Taxation of Financial Products 19 (Summer 2002); Edward D. Kleinbard, Risky and Riskless Positions In Securities, 71 Taxes 783 (1993).
4. An over-the-counter derivative is not traded on an established market.
5. See David M. Schizer, Frictions as a Constraint on Tax Planning, 101 Columbia Law Review 1312, 1349-1356 (October 2001).
6. Schizer, Frictions..., *supra* at 1353-1355 (reporting the use of a trust structure derivative by individuals with positions having a value of \$75 million or more).
7. Investors may desire to take a long position in a trust structure VPFC because the derivative financial instruments typically provide a coupon payment that exceeds the dividend on the underlying shares. This permits investors who would otherwise eschew investments in low or non-dividend paying stocks (e.g., growth stocks) to invest in the issuer while earning a current return. See Linda E. Carlisle, Financial Products Exchangeable into Common Stock: Tax Opportunities and Issues, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings – 2002, 553 Practising Law Institute 268 Volume 16 (2002) at 1268-1270; David M. Schizer, "Debt Exchangeable for Common Stock: Electivity and the Tax Treatment of Issuers and Holders," 1 Derivatives Report 7 (March 2000).
8. For a discussion of Revenue Ruling 2003-7 and the taxation of VPFCs, see James H. Combs, Will Variations Pave the way For Consistency? Implications of Revenue Ruling 2003-7 for Structuring VPFCs (and Other Financial Transactions?) (unpublished manuscript on file with authors).
9. Corporations also issue VPFC-type instruments generally known as "debt exchangeable for common stock." See, e.g., Robert S. Bernstein, Are VPFCs, Collars, and DEC's Still Viable Hedging and Monetization Strategies? 30 Corporate Taxation 2 (March/April 2003).
10. See *Cruttenden v. U.S.*, 644 F.2d 1368 (9th Cir. 1981); *Lorch v. Commissioner*, 70 T.C. 674 (1978), *aff'd*, 605 F.2d 657 (2nd Cir. 1979), *cert. denied*, 444 U.S. 1076 (1980); and *Miami National Bank v. Commissioner*, 67 T.C. 793 (1977).
11. See *Richardson v. Commissioner*, 121 F.2d 1 (2nd Cir. 1941), and *Klinger v. Commissioner*, 1949 PH T.C. Memo ¶49,132.
12. 55 T.C. 1020 (1971), *aff'd*, 471 F.2d 738 (3rd Cir. 1973), *cert. denied*, 414 U.S. 824 (1973). The IRS had previously cited *Hope* in a field service advice ("FSA") that concluded that execution of another VPFC-type contract had resulted in a current sale of stock. The analysis in FSA 200111011 (December 6, 2001) was heavily criticized by commentators because it employed a benefits and burdens test of ownership applied to property other than publicly traded securities. See Rudnick and Petock, *supra*. The publication of Revenue Ruling 2003-7 generally has made FSA 200111011 of historical interest only.
13. Government officials have subsequently downplayed the necessity of having an unrelated, third party trust hold the pledged shares. See Sheryl Stratton, Dilating Derivatives Guidance Requires Industry Input, IRS Says, 99 Tax Notes 9 at 1315 (June 2, 2003) (reporting comments of Christina Morrison, IRS associate chief counsel (Financial Institutions and Products)). In many VPFC transactions, an affiliate of the financial institution will act as the collateral agent. The affiliate will often seek the right to borrow the shares pledged as security in order to provide a ready source of shares available for hedging through short sales of the stock. Although the right to borrow itself may not affect the open transaction status of the forward sale, an actual borrowing may not be protected by IRC § 1058 and could result in a taxable event. See Shapiro, *supra* at 169; Schizer, Frictions..., *supra* at 1355-1356.

ENDNOTES continued

14. Revenue Ruling 2003-7 does not provide any cites to authority for the inclusion of these factors nor does the revenue ruling provide much helpful detail on how these factors will be applied. In Revenue Ruling 2003-97, 2003-34 I.R.B. 1, which involved a similar forward sale of securities, the IRS did cite cases and rulings (including Revenue Ruling 2003-7) that considered "unrestricted legal rights" and "economic compulsion." These cases and rulings presumably are relevant to applying the two factors for purposes of Revenue Ruling 2003-7. See also Shapiro, *supra* (discussing these factors).
15. The revenue ruling stated that an expectation that the taxpayer would have insufficient resources to deliver property other than the pledged shares on the settlement date is an example of economic compulsion.
16. See Shapiro, *supra* (concluding that the execution date of the contract is the relevant testing date).
17. The TAM stated that the facts did not indicate economic compulsion.
18. In a footnote, the TAM indicates that the Shareholder could exercise the cash settlement option without restriction as of the Option Date.
19. Revenue Ruling 2003-7 does not treat the VPFC as a combination of financial transactions that includes a debt component. See John F. Prusiecki, Interesting Implications of Revenue Ruling 2003-7, 98 Tax Notes 775 (February 3, 2003). The similarities of VPFCs to other financial transactions, including debt instruments, have been noted by commentators. See, e.g., David F. Levy, Disparities in Treatment Among Prepaid Forward Contracts, Deep in the Money Options, Prepaid Swaps, and Contingent Debt Instruments, Derivatives (November/December 1998); Edward D. Kleinbard and Erika W. Nijenhuis, Everything I Know About New Financial Products I Learned From DECS, 553 PLI 260 Volume 16. The status of a VPFC as an instrument other than debt (or a combination of instruments with a debt component) raises the issue of whether such contracts give rise to a liability under IRC § 752.
20. See IRC § 752(a).
21. See IRC § 752(b).
22. See IRC §§ 722, 733.
23. See IRC § 731.
24. See Treas. Reg. § 1.707-3.
25. See Treas. Reg. § 1.707-3(b), (c).
26. See Treas. Reg. § 1.707-5(b)(1).
27. See Treas. Reg. § 1.707-5(b)(2).
28. See Treas. Reg. §§ 1.707-5(a)(2)(i); 1.752-2.
29. See Treas. Reg. §§ 1.707-5(a)(2)(ii); 1.752-3.
30. In addition, the IRS ruled in TAM 200341005 that the Series A Sub Trust was a grantor trust whose grantor was the Partnership. Accordingly, the Trust Obligation was treated as a liability of the Partnership and the distributions from the Series A Sub Trust to the Partnership was without tax consequence.
31. In June of 2003, the IRS issued proposed regulations, which are discussed below, defining liability for purposes of IRC § 752.
32. 1988-2 C.B. 128.
33. IRC § 705(a)(2)(B) provides that expenditures of the partnership not deductible in computing taxable income and not properly chargeable to the capital account decrease a partner's basis in his partnership interest.
34. Shortly after the issuance of Revenue Ruling 88-77, the IRS issued temporary regulations defining liability for purposes of IRC § 752. See Former Temp. Treas. Reg. § 1.752-1T(g). The definition under the temporary regulations was substantially the same as the definition in Revenue Ruling 88-77. The temporary regulations defined liability as an obligation giving rise to: (i) the creation of, or an increase in, the basis of any of the obligor's property (including cash attributable to borrowings), (ii) a deduction taken into account in computing taxable income of the obligor, or (iii) a nondeductible, noncapitalizable expenditure. When the temporary regulations were finalized, however, the definition of liability was excluded without explanation. The preamble to proposed regulations issued in June of 2003, which are discussed below, indicates that the definition of liability in the temporary regulations was excluded because, in light of Revenue Ruling 88-77, the definition was redundant and unnecessary. See Preamble to Prop. Treas. Reg. § 1.752-1 (6/24/2003) (Fed. Reg. Vol. 68, No. 121, p. 37434). The issuance of the temporary regulations was precipitated by Congress' view, as expressed in the legislative history of the Deficit Reduction Act of 1984, that accounts payable of a cash basis partnership should not be treated as liabilities, as they had been in Revenue Ruling 60-345, 1960-2 C.B. 211, *revoked by* Rev. Rul. 88-77, 1988-2 C.B. 128, unless they give rise to a deduction or increase the basis of a partnership asset.
35. 1995-1 C.B. 131.
36. 1973-2 C.B. 215.
37. Commentators have suggested that the holding in Revenue Ruling 73-301 may possibly be reconciled with Revenue Ruling 88-77 on the basis that the partnership had earned the progress payments and had no obligation to return them if it failed to perform additional services under the construction contract. See Monte A. Jackel and Jerred G. Blanchard, Jr., Reflections on Liabilities: Extension of New Law to Partnership Formations, 91 Tax Notes 1579, 1589 (May 28, 2001).
38. T.C. Memo 1975-160.

ENDNOTES continued

39. The regulations under IRC § 752 suggest that contingent obligations are not liabilities for purposes of IRC § 752. See Treas. Reg. § 1.752-2(b)(4). In addition, before the IRS issued Revenue Ruling 88-77, the Tax Court in one case had held that contingent obligations do not increase partners' basis under IRC § 752. See *Long v. Commissioner*, 71 T.C. 1 (1978), *aff'd in part and rev'd in part on other issues*, 660 F.2d 416 (10th Cir. 1981). However, under proposed regulations issued in June of 2003, which are discussed below, a contingent obligation may be treated as a liability for purposes of IRC § 752. See Prop. Treas. Reg. § 1.752-1(a)(1).
40. See Jackel and Blanchard, *supra* at 1590. But see William S. McKee, William F. Nelson and Robert L. Whitmire, *Federal Taxation of Partnership and Partners* ¶ 7.01[1] n. 10 ("contested or contingent liabilities are not deductible until the requirements of § 461 are satisfied and should not be treated as § 752 liabilities until they become deductible.")
41. T.C. Memo 2000-352.
42. The IRS also relied on the former temporary regulation described in footnote 32, *supra*.
43. Assuming the court's analysis is correct, there are nevertheless good arguments that a forward seller's obligation to deliver securities and/or cash under a VPFC should not be treated as a liability for purposes of IRC § 752. In this regard, commentators have argued that obligations under VPFCs and short sales are substantively different because VPFCs are executory contracts and short sales are borrowing transactions. See Bruce Lemons, James Whitmire and Randy Bickham, *The New Definition of "Liability" and its Effect on Prepaid Forward Contracts*, *Tax Notes Today* (September 9, 2003).
44. See Prop. Treas. Reg. § 1.752-1(a)(1).
45. See Preamble to Prop. Treas. Reg. § 1.752-1(a)(1) (6/24/2003) (Fed. Reg. Vol. 68, No. 121, p. 37434).
46. See IRC § 6662(b)(2).
47. See IRC § 6694.
48. See Chief Counsel Notice 2003-014 (May 8, 2003), *superceding* Chief Counsel Notice 2002-043 (Oct. 17, 2002).
49. See *id.*; see also Sheldon I Banoff and Richard M. Lipton, *IRS Chief Counsel Will Follow Prop. Regs. — Sometimes!*, 98 *Journal of Taxation* 380 (June 2003); Sheldon I Banoff and Richard M. Lipton, *IRS Chief Counsel Will Follow Prop. Regs. — But Don't Plan on Them!*, 98 *Journal of Taxation* 187 (March 2003).