The Tax Treatment of Exchange-Traded Notes: Here We Go Again

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Exchange-traded notes (ETNs) are relatively new financial products that were initially introduced by Barclays in June 2006. ETNs are contractual obligations of the issuer to pay an amount based on changes in the value of an index, and are traded on a major exchange (for example, the New York Stock Exchange). The holder pays an upfront payment to the issuer for the right to receive a return that is based on changes in the value of a recognized index, such as commodities, stock, and foreign exchange indices. House Ways and Means Committee member Richard E. Neal, D-Mass., has recently proposed legislation that would address the tax treatment of ETNs along with similar products such as prepaid forward contracts. Also, the IRS has recently issued two documents with respect to prepaid forward contracts, indicating that further guidance is on its way. It looks like the growing interest in ETNs may result in a more comprehensive revisit of the tax treatment of prepaid forward contracts by Congress or Treasury.

In this article, the authors begin with a detailed description on what ETNs are and how they work. The authors further discuss the recent developments in the taxation of prepaid forward contracts in general and ETNs in particular, and explore the different routes that Congress, Treasury, and the IRS may take for the taxation rules for those instruments.

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I. Introduction[1]

The debate over the appropriate tax treatment of forward contracts — in particular, prepaid forward contracts — has been reignited by the recent market introduction and growth of financial products commonly referred to as exchange-traded notes, or ETNs. ETNs were first issued by Barclays Bank PLC in June 2006 under the trade name iPaths, and several other financial institutions have since gone to market with their own versions of ETNs.[2] The mutual fund industry is unhappy about ETNs, which it views as a competing product with superior tax consequences.[3] The industry apparently has convinced some in the tax policy community that this is

[1]All statutory and regulatory references in this article are references to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

[2]The original iPath ETNs were 30-year secured securities listed on the New York Stock Exchange. These ETNs promised to pay investors the return of a commodity index (the Goldman Sachs Commodities Index (GSCI) and the Dow Jones-AIG Commodity Index), minus annual fees of 75 basis points. As discussed below, later issuances of ETNs have expanded the scope of underlying indices to include stock and foreign currency exchange indices.

[3]During the first week of November 2007, two competing letters were sent to the House Committee on Ways and Means pertaining to the taxation of ETNs. On November 1, 2007, the Investment Company Institute (ICI) urged the committee to advance legislation that would eliminate the tax deferral associated with ETNs. The ICI was concerned that ETNs received favorable treatment compared to that of mutual funds, even though both investment vehicles shared many similarities. The Securities Industry and Financial Markets Association (SIFMA) responded four days later with its own letter to the committee,

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a case of disparate tax treatment of equivalent financial products, and that action is required to address this inconsistent taxation.[4]

The cause of the mutual fund industry's anxiety is the characterization of ETNs by the financial institutions and their tax counsel as prepaid forward contracts for tax purposes.[5] While the tax treatment of prepaid forward contracts never has been specifically codified, there is general acknowledgement that prepaid forward contracts are taxed in a manner similar to that of traditional forward contracts and in accordance with the open transaction doctrine, which generally defers the tax consequences of entering into a forward contract until the contract is fully executed.[6]

Of course, prepaid forward contracts have been around for years, as have the periodic discussions about their proper taxation.[7] This time around, the scrutiny of prepaid forward contracts is due to a product that is not particularly complex, exotic, or innovative, except perhaps in its marketing.[8] In essence, what in the past had been sold almost exclusively to institutional investors and high net worth individuals has been repackaged for sale to retail investors for whom liquidity is a prerequisite in their investment decisions.[9]

urging the committee not to impose current taxation on investors in ETNs. The SIFMA letter explained that ETNs and mutual funds should be taxed differently because they are fundamentally different products.

[4]On March 5, 2008, the House Ways and Means Select Revenue Measures Subcommittee conducted an informative but inconclusive hearing concerning the tax treatment of derivatives, which in large measure focused on the concerns of the mutual fund industry about the tax treatment of ETNs. To accompany the hearing, the Joint Committee on Taxation issued a report discussing tax consequences of derivatives in general, and prepaid forward contracts in particular. *See* Joint Committee on Taxation, "Present Law and Analysis Relating to the Tax Treatment of Derivatives" (JCX-21-08), Mar. 4, 2008, *Doc 2008-4664, 2008 TNT 44-15.*

[5]*See* Rev. Rul. 2003-7, 2003-1 C.B. 363, *Doc 2003-1634, 2003 TNT 12-13.* While ETNs obviously were not discussed in this revenue ruling and were not specifically referred to in the subsequent proposed guidance discussed below, it seems very clear that any future guidance on prepaid forward contracts would apply to ETNs.

[6]*Id. See also* JCX-21-08, *supra* note 4, at 17, 28-29.

[7]*See* Michael Farber, "Equity, Debt, NOT — The Tax Treatment of Non-Debt Open Transactions," 60 *Tax Lawyer* 635 (Spring 2007); Rosenthal and Dyor, "Prepaid Forward Contracts and Equity Collars: Tax Traps and Opportunities," *Tax. Fin. Prod.* (Winter 2001), at 35. *See also* JCX-21-08, *supra* note 4, at 7. ("Prepaid forward contracts were relatively uncommon in the markets until the development of publicly traded forward (not futures) contracts some 15 years ago. When those contracts first were considered, their sponsors needed to address the fundamental credit problem of assuring performance by members of the public who were forward buyers. This problem was solved by requiring that the forward buyer pay to the forward seller at the outset, rather than at maturity, the amount due under the contract.")

[8]*See* JCX-21-08, *supra* note 4, at 26.

[9]*See generally id.* at 28 n.38, stating that ETNs are a different version of the traditional prepaid forward contracts.

The debate over the tax policy implications of ETNs continues to unfold.[10] Only time will tell whether ETNs will bring about any significant tax law changes and, if so, how broadly those changes would alter the landscape of financial products taxation. However, the IRS already has acted with unusual speed in addressing one particular type of ETN.[11] Also, legislation recently was introduced that not only would codify a tax treatment of ETNs different from that proffered by the financial institutions offering ETNs, but also would fundamentally reshape the overall tax treatment of prepaid forward contracts.[12]

This article first reviews the current tax treatment of forward contracts in general, and variable prepaid forward contracts in particular (of which ETNs are but one species). The article continues with a general description of ETNs and an overview and analysis of both the recent IRS guidance and the recently introduced legislation. The article then discusses the intended tax treatment of ETNs, along with the tax consequences of similar financial instruments. Finally, the article concludes with some general thoughts about the coming debate over ETNs specifically, prepaid forward contracts more broadly, and perhaps even the entire framework of financial products taxation.

II. Variable Prepaid Forward Contracts

A. Overview

Prepaid forward contracts take many different forms.[13] One particular type of prepaid forward contract is a variable prepaid forward contract, which was the subject of IRS guidance in Rev. Rul. 2003-7.[14] As discussed below, it is expected that any future guidance pertaining to ETNs would, in fact, come in the form of comprehensive guidance on the tax treatment of prepaid forward contracts.[15] Furthermore, because the return on ETNs is subject to variation, that guidance very likely would address the tax treatment of variable prepaid forward contracts in general.[16] This section sets forth the background for understanding variable prepaid forward contracts, and how they have been — and should be — treated for tax purposes. To understand how variable prepaid forward contracts work, it is best to isolate the three separate elements of the contract: (1) a forward contract (2) that is variable and (3) is prepaid.[17]

[10]*See generally id.* at 26-34, discussing the various prevailing views for the tax treatment of prepaid forward contracts in general, and ETNs in particular.

[11]Rev. Rul. 2008-1, 2008-2 IRB 1, *Doc 2007-26968, 2007 TNT 237-8.*

[12]H.R. 4912, introduced on December 19, 2007, by Rep. Richard Neal, D-Mass.

[13]*See generally* Farber, *supra* note 7, at 639-41; JCX-21-08, *supra* note 4, at 26-27.

[14]2003-1 C.B. 363, *Doc 2003-543, 2003 TNT 4-9.*

[15]This view was clearly stated by government officials in the recent midyear meeting of the American Bar Association Section of Taxation (Jan. 17-19, 2008).

[16]*See generally* JCX-21-08, *supra* note 4.

[17]*See generally* James Combs, "Will a Variation Lead to Consistency? Implications of Forward Contract Ruling for

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1. What is a forward contract? A forward contract is an agreement under which a buyer agrees to buy from a seller an underlying asset for a fixed price (delivery price) on a single specified date in the future (delivery date), the terms of which are initially set so that the present value of the contract is zero.[18] A forward contract is defined for tax purposes as a privately negotiated contract that provides for the sale and purchase of property for a specified price on a specified date.[19]

Until the forward contract is sold, exchanged, settled, or allowed to lapse, the transaction is treated as an open transaction and any gain or loss to the parties is deferred.[20] On the delivery of the underlying property, gain or loss to the seller is generally capital to the extent the underlying asset would be a capital asset in the seller's hands.[21]

A taxpayer who owns property and enters into a forward contract with respect to the same property is generally not treated as having sold the property when it enters into the forward contract.[22] If the forward contract is closed by physical delivery of the property, the recipient of the property is not taxed until further disposition of the property and the recipient's basis in the forward contract becomes its basis in the property.[23]

The seller may have a very low basis in the underlying asset and, by virtue of entering into the forward contract, the seller locks in the gain. Following the enactment of section 1259 in 1997, holding an appreciated asset and entering into a forward contract could trigger current recognition as a constructive sale under section 1259.[24] As discussed below, it did not take too long for the major banks to design contracts that would achieve very similar results (that is, locking in most, but not all of the gain), while still avoiding constructive sales consequences.

2. Variable forward contracts. Several variations of forward contracts emerged in the 1990s, some of which were driven by tax considerations, especially avoiding section 1259.[25] These variations include prepaid forward contracts, variable forward contracts, and, combining the two, variable prepaid forward contracts.[26]

Variable forward contracts were developed primarily to avoid the constructive sale rules for holders of appreciated assets, while still providing a level of protection against a decline in the stock's value.[27] Section 1259(d)(1) defines a forward contract, for purposes of section 1259, as "a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price." The consideration the seller will receive in a variable forward contract is fixed but the number of shares it is required to deliver on the exercise date is variable.[28] Thus, a variable forward contract providing for delivery of property (such as shares of stock), the amount of which is subject to significant variation under the contract terms,[29]

Hedging Appreciated Stock," *Tax Notes*, Mar. 8, 2004, p. 1245, *Doc 2004-3663, 2004 TNT 46-50.*

[18]*See* Alvin C. Warren, "Financial Contract Innovation and Income Tax Policy," 107 *Harv. L. Rev.* 460 (Dec. 1993), at 464 ("A forward contract is an executory agreement to sell a specified asset at a currently agreed price on a certain date in the future."); David C. Garlock, "The Proposed Notional Principal Contract Regulations: What's Fixed? What's Still Broken?" *Tax Notes*, Mar. 22, 2004, p. 1515, *Doc 2004-5397, 2004 TNT 56-26*, at 1523. ("'Forward contract' . . . can be understood to mean a contract to purchase a specified asset on a specified date for a fixed price, which may or may not be prepaid.") *See generally* JCX-21-08, *supra* note 4 (discussing the fundamentals of forward and futures contracts, including prepaid forward contracts).

[19]*Glass v. Commissioner*, 87 T.C. 1087, 1101 (1986). Section 1260(d)(4) defines a forward contract as any contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.

[20]*See* David S. Miller, "Taxpayers' Ability to Avoid Tax Ownership: Current Law and Future Prospects," 51 *Tax Law.* 279, 305 (notes 101-104 and accompanying text). *See generally* JCX-21-08, *supra* note 4 (discussing the tax rules for forward contracts in the United States).

[21]*See* Gregory May, "The U.S. Taxation of Derivative Contracts," *Tax Notes*, Sept. 25, 1995, p. 1619, *95 TNT 190-56*. ("[The open transaction] result seems relatively unsurprising in the case of a forward. No cash passes until the performance date, and the seller does not become entitled to anything until the contract period has elapsed.")

[22]*See Lucas v. North Tex. Lumber*, 281 U.S. 11 (1930). Thus, a forward contract constitutes an open transaction, similar to an option, until it is sold, exchanged, settled, or allowed to lapse. *See also* JCX-21-08, *supra* note 4.

[23]*See* JCX-21-08, *supra* note 4, at 17.

[24]Section 1259 provides that if a taxpayer holds an "appreciated financial position" (including stock) and enters into, among other things, a fixed price forward contract to sell that stock (or substantially identical property), the taxpayer will be treated as having made a "constructive sale" of the stock and as a result will realize gain as if the position had been sold.

[25]Dana L. Trier and Lucy W. Farr, "Constructive Sales Under Section 1259: The Best is Yet to Come," 16 *Practicing Law Institute, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 1217, 1223 (2002). *See also* Combs, *supra* note 17.

[26]*Id. See also* David Weisbach, "Tax Response to Financial Contract Innovation," 50 *Tax L. Rev.* 491, 498 (1995). ("A prepaid forward looks much like a contingent payment debt instrument except that the amount guaranteed to be returned is not sufficient for the instrument to be classified as debt for tax purposes.")

[27]*See* Edward D. Kleinbard and Erika W. Nijenhuis, "Everything I Know About New Financial Products I Learned from DECS," 16 *Practicing Law Institute, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 485, 491-493 (2002). *See also* Combs, *supra* note 17.

[28]*Id.* The formula for the number of shares to deliver is: (1) a specified maximum number of shares must be delivered if the price of the stock is at or below the floor price; (2) a specified fraction of that number of shares must be delivered if the stock appreciates above the cap price; and (3) if the stock is between the floor price and the cap price, the shares to be delivered will have a fair market value equal to the consideration. The fraction is the ratio of the floor price to the cap price. Floor price is typically the initial value of the stock.

[29]*See* Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997" (JCS-23-97), Dec. 17, 1997, p. 176, *Doc 97-33838, 97 TNT 245-64* (legislative history mentioning "significant variation" and "substantially fixed" but not providing examples relating to forward contracts).

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coupled with a long-appreciated position in the same property, is likely not a constructive sale under section 1259.[30]

While this type of transaction allowed holders of an appreciated position to lock in most of their gains, it still did not allow the holders immediate access to cash. Thus, prepaid variable forward contracts were developed to allow holders of appreciated property to monetize their position while still avoiding recognition of gains under section 1259.

3. Variable prepaid forward contracts. A variable prepaid forward contract provides its buyers with a return similar to a variable forward contract, except that the seller receives up front the discounted value of the cash it would receive on a full physical settlement of the contract.[31]

In Rev. Rul. 2003-7, the IRS concluded that a variable prepaid forward contract involving stock would not be treated as a sale of the stock.[32] Rev. Rul. 2003-7 considered the following factual situation: A taxpayer holds appreciated stock of a publicly held corporation and enters into a variable prepaid forward contract with an investment bank under which the taxpayer receives an upfront cash payment from the bank and becomes obligated to deliver a variable number of shares of the stock at the termination of the contract. The number of shares to be delivered is to be determined in accordance with a preestablished formula. The ruling concludes that the taxpayer should not be treated as selling the underlying stock because: (1) the taxpayer had an unrestricted right to substitute cash or other shares for the stock; (2) the taxpayer was not economically compelled to deliver the stock on the termination date; and (3) the taxpayer retained the right to receive dividends and to vote the stock during the three-year term of the contract.[33]

However, the IRS determined in a chief counsel memorandum issued several years later that a variable prepaid forward contract for the sale of stock and a share lending agreement that involve the same parties and refer to the same shares result in a current sale of the shares.[34]

The memorandum's conclusion is consistent with the conclusion reached by the IRS earlier in TAM 200604033. In that TAM, the taxpayer entered into several variable prepaid forward transactions through a master stock purchase agreement (MPA). The MPA required the taxpayer to pledge the shares and also to allow the counterparty to borrow the pledged shares. The IRS concluded that a sale occurred when the shares that had been pledged to the counterparty under the prepaid variable forward contract were loaned to the counterparty under the share lending agreement and were sold short by the counterparty.[35] The IRS ruled that Rev. Rul. 2003-7 did not contemplate delivery of the pledged shares to the counterparty at the time the shares were pledged. According to the IRS, the amount realized was the full value of the shares, even though the taxpayer had the right to get back up to one-sixth of the shares pledged and loaned.[36]

The IRS also supported its conclusion in the TAM on the grounds that the variable prepaid forward contract and the stock loan were part of a single transaction. Thus, the results could be different if a similar transaction is structured so that the stock loan is separate from the forward contract.[37] Indeed, this issue is now being considered by the Tax Court, which may shed more light on the question when and if it reaches a decision and renders an opinion.

III. Exchange-Traded Notes

ETNs are sold by financial institutions to investors in the form of debt instruments issued by the institution (or an affiliate), and are treated as such for financial accounting purposes.[38] Practitioners and commentators generally refer to ETNs and other equity-linked instruments that are labeled as debt instruments as "structured notes."[39] A structured note generally is a security that is documented as a debt instrument but the return on which is based on the performance of one or more assets,

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[30]In the absence of a clear threshold, practitioners and commentators have speculated on the possible safe harbors under section 1259, generally with reference to other uses of the term "substantially all" in the code and regulations. *See* comment letter dated January 22, 1998, from William McClure and Geoffrey Lanning to Donald C. Lubick, Treasury assistant secretary for tax policy, *Doc 98-8056, 98 TNT 43-23* (Mar. 5, 1998); William Paul, "Constructive Sales under New Section 1259," *Tax Notes*, Sept. 15, 1997, p. 1467, *Doc 97-25853, 97 TNT 178-63.*

[31]Alex Raskolnikov, "Contextual Analysis of Tax Ownership," 85 *B.U.L. Rev.* 431, 442-443 (2005). Any forward contract can be prepaid, not just variable forward contracts.

[32]*See* Combs, *supra* note 17. *See also* TAM 200604033, *Doc 2006-1643, 2006 TNT 19-17* (Rev. Rul. 2003-7 does not apply to variable prepaid forward contracts together with share loan).

[33]However, the ruling indicates that had the taxpayer been under legal obligation or restriction to deliver the stock, the result would have been different.

[34]*See* AM-2007-004, *Doc 2007-2878, 2007 TNT 24-26.* In a recent coordinated issue paper, the IRS addressed a similar type of a prepaid forward contract in which a taxpayer holds an appreciated position in stock, and enters into a variable prepaid forward contract with a bank, that includes a share lending of the same stock. The IRS concluded that under those circumstances, the transaction should be treated as a current sale of the underlying stock, as opposed to an open transaction. *See* LMSB-04-1207-077, coordinated issue paper, "Variable Prepaid Forward Contracts, Incorporating Share Lending Arrangements" (Feb. 8, 2008), *Doc 2008-2641, 2008 TNT 27-46.*

[35]*Supra* note 32. *See also* LMSB-04-1207-077. An alternative theory proposed by the IRS was that gain was triggered by the sale of the loaned shares and section 1058(b)(3) precluded nonrecognition.

[36]*Id. See also* LMSB-04-1207-077, *supra* note 34.

[37]In view of section 1058(b)(3), the variable prepaid forward contract and the stock loan must be separate agreements if the taxpayer is to be able to rely on section 1058.

[38]*See* Rev. Rul. 2008-1 (discussed below) for a description of a particular type of ETN (based on currency exchange rates) that, according to the IRS, is properly treated as debt for tax purposes. *See also* JCX-21-08, *supra* note 4, at 26.

[39]Another term used for those products is "mandatory convertibles." *See* JCX-21-08, *supra* note 4, at 26-27.

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or an index of assets.[40] Structured notes have been around for many years, but in the past have been traded only privately. ETNs are simply an exchange traded version of structured notes, and are listed on major public stock exchanges such as the New York Stock Exchange, so investors can make secondary market purchases and sales of ETNs just as they would any publicly traded stock.[41] ETNs also can be redeemed before maturity (at the option of the investor). With their combination of public trading and early redemption features, ETNs are designed for liquidity, giving them a distinct advantage in the retail investor market over structured notes and other comparable instruments, such as prepaid forward contracts, that traditionally can be traded only over the counter.

An ETN is acquired with an upfront payment to the issuer (if the holder purchases the ETN at original issuance) or the seller (if the holder purchases the ETN on a secondary market). The holder acquires no interest in the underlying assets that are included in the index, and obtains no right to control (for example, through the exercise of voting rights on common stock) or receive the underlying assets at any time.[42] ETNs essentially are bare contracts between the issuing financial institution and the holder. On this basis, ETNs can be contrasted with other financial products that may share similar investment features and objectives, such as exchange traded funds and mutual funds. Because they require a cash investment on acquisition by the holder, ETNs also can be contrasted with other publicly traded contracts (such as futures), which are traded on margin.

The investment return on ETNs depends primarily on the value of a specific market index when the ETN is disposed of or matures.[43] If the index appreciates in value, the holder's return on the ETN will exceed his investment (less any fees paid to the issuer). If the index declines in value, the holder will end up with less than his investment.[44] The types of indices that can be tracked are virtually unlimited, and the ETNs available in the market track indices in everything from physical commodities and currency exchange rates to baskets of equities.[45] Most of the existing ETNs have 30-year maturity dates, although some have maturity dates as short as 5 years. In most (but not all) cases, ETNs do not pay a current yield. Rather, any dividends or other current yield generated by the underlying investment generally are treated as reinvested in the index, which increases the holder's notional investment amount. The index typically is rebalanced periodically.

IV. Recent IRS Guidance

In December 2007, the IRS issued two pronouncements regarding prepaid forward contracts, ETNs, and similar instruments, indicating that more comprehensive guidance may be on its way.

A. Rev. Rul. 2008-1

In Rev. Rul. 2008-1,[46] the IRS ruled that an ETN, the return on which is based on changes in the value of foreign currency, constitutes debt for federal income tax purposes even though the holder's initial investment and repayment are made in U.S. dollars and the holder may get back fewer U.S. dollars than it invested. The IRS explained that debt denominated in a foreign currency does not lose its essence as debt merely because payments on the debt are converted into a different currency.

The facts in this ruling were as follows: On January 1, 2007, the exchange rate of U.S. dollars for euros was $1 = €0.75.[47] On that date, a holder delivered $100 to the issuer in exchange for the issuer's obligation to deliver to the holder, on January 1, 2010, the U.S. dollar equivalent of an amount of euros. The settlement amount will be determinable on January 1, 2010 and will equal the sum of the following amounts translated into U.S. dollars at the spot rate on January 1, 2010: (1) €75, and (2) an amount of euros calculated by reference to a compound rate of return[48] applied to €75 from January 1, 2007, until January 1, 2010.[49]

The ruling assumes that: (1) both the holder and issuer expect that the issuer will pay the holder the settlement amount when due on January 1, 2010; and (2) the legal remedies provided in the instrument are not materially different than legal remedies associated with instruments that are debt for federal tax purposes.

Obviously, to constitute a debt instrument, the contract must provide the buyer with a guaranteed return equal at least to the buyer's investment. Nevertheless, even though the IRS observed that at the time of issuance there was a significant possibility that the amount payable by the issuer to the holder on January 1, 2010, would be significantly less than $100, it concluded that "the fact

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[40]Comprehensive guidance on the accounting treatment of structured notes can be found in Financial Accounting Standard 133 and related pronouncements.

[41]*See* JCX-21-08, *supra* note 4, at 26-27.

[42]This feature contrasts with a typical forward contract, which permits the investor to obtain physical possession of the underlying asset.

[43]Similarly, a variable prepaid forward contract provides its buyer with the right to a return on a specific stock, subject to a cap.

[44]*See* JCX-21-08, *supra* note 4, at 27, referring to this type of investment as an "actual investment in Dogs of the Dow stocks."

[45]*See generally id.* at 26. ("Existing ETNs generally are intended to provide investors the returns of specified market indices (less fees owed to the issuing bank). Examples of returns tracked by these indices include changes in the values of physical commodities, currency exchange rate movements, and

(Footnote continued in next column.)

the performance of developing market equities or other groups of equities.") Note that JCX-21-08 focuses only on ETNs that reference stock.

[46]2008-2 IRB 1, *Doc 2008-584*, *2008 TNT 9-3*.

[47]The U.S. dollar is the functional currency of the holder.

[48]The compound rate of return is the excess of a rate based on euro interest rates over a rate labeled as a "fee" for the benefit of the issuer.

[49]Alternatively, the IRS observed that the settlement amount to be paid by the issuer on January 1, 2010, may also be determined by reference to a mathematical formula that generates the same substantive effect as the methodology described above.

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that intervening currency fluctuations may cause the amount of U.S. dollars that Holder receives at maturity (on January 1, 2010) to be less than the amount of U.S. dollars that the Holder paid for the Instrument (on January 1, 2007) does not affect the characterization of the Instrument as debt, which is based on an analysis of payments with respect to the euro."[50]

The issue discussed in this ruling was narrower than the more general controversy that pertains to ETNs, most of which clearly are not debt instruments. However, the IRS stated in the accompanying Notice 2008-2 that it seeks comments on prepaid forward contracts in general,[51] thereby signaling that ETNs are on the IRS's radar screen and that more comprehensive guidance may be on the way.[52]

B. Notice 2008-2

On the same day it issued Rev. Rul. 2008-1, the IRS also issued Notice 2008-2, seeking comments on several tax aspects of prepaid forward contracts or similar arrangements, including ETNs, that otherwise are not treated as debt for tax purposes.

The IRS observed that these instruments resemble typical forward contracts, with the only difference being that the purchase price is paid in advance. Consistent with recently introduced legislation (discussed below), the IRS and Treasury stated in the notice that they "are considering whether the parties to such a transaction should be required to accrue income/expense during the term of the transaction, if the transaction is not otherwise indebtedness for U.S. federal income tax purposes."

The notice specifically requested comments on the following issues:

1. the appropriate method for accruing income or expense, if that is deemed appropriate (for example, a mark-to-market method or a method resembling the noncontingent bond method for contingent payment debt instruments (CPDIs));[53]

2. how an accrual regime should be designed so that it does not inappropriately or inadvertently cover routine commercial transactions involving property sales in the ordinary channels of commerce;

3. the character of income accruals required under such an accrual regime, as well as the character of amounts less than, or in excess of, these accruals;

4. whether the tax treatment of the transactions should vary depending on the nature of the underlying asset;

5. whether the tax treatment of the transactions should vary depending on whether the transactions are (i) executed on a futures exchange, or (ii) memorialized in an instrument that is traded on a securities exchange;

6. whether the transactions should be treated as indebtedness under regulations issued under section 7872;

7. whether section 1260 applies, or should apply, to those transactions;[54]

8. the degree to which those transactions (and any income accruals that may be mandated) should be taxed as U.S.-source income under sections 871 and 881;

9. how the income with respect to those instruments should be treated for purposes of section 954;

10. how investments in those contracts should be treated under section 956;

11. whether there are other issues that should be considered regarding these transactions (for example, short-term transactions);

12. identifying arrangements similar to prepaid forward contracts that should be accorded tax treatment similar to that of prepaid forward contracts; and

13. appropriate transition rules and effective dates.

If Treasury were to await comments on all of these questions, it obviously would take years until guidance is issued, and the recently introduced legislation would address only some of the issues. Therefore, it is likely that the next authoritative piece of guidance (either in the form of enacted legislation or administrative pronouncement) would be limited in scope and would not address all of these questions.

V. H.R. 4912

On December 19, 2007, Rep. Richard E. Neal, D-Mass., a senior member of the House Ways and Means Committee and chair of the committee's Select Revenue Measures Subcommittee, introduced legislation (H.R. 4912) that would significantly alter the tax treatment of prepaid forward contracts. While the legislation is inspired by the arrival of ETNs onto the financial products scene, it would apply to a much wider range of prepaid forward contracts.[55]

The introduction of H.R. 4912 was accompanied by the release of a detailed technical explanation of the legislation.[56] The technical explanation argues that ETNs "raise two different but overlapping important federal income

[50] *See* reg. section 1.988-5(a)(9)(iv) (Example 6) (currency-linked contract is debt even if full U.S. dollar amount may not be recovered).

[51] As the IRS stated, "the Instrument, in form, resembles a U.S. dollar denominated derivative contract in which the Holder prepays its obligations under the contract, and is entitled to receive a return based exclusively on the value of property at maturity." (*See* Notice 2008-2, 2008-2 IRB 252, *Doc 2007-26969, 2007 TNT 237-10*, dated Jan. 14, 2008, requesting comments with respect to these types of derivative contracts.)

[52] Recent comments during the ABA tax section's midyear meeting indicated that Rev. Rul. 2008-1 was only the "tip of the iceberg" in the government's attempts to address ETNs.

[53] *See* generally JCX-21-08, *supra* note 4 (discussing some of these issues).

[54] *See id.* (discussing a similar alternative).

[55] *See generally id.*

[56] The text of the technical explanation is available at http://www.house.gov/neal/news/news94.html.

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tax issues," both of which involve the tax deferral associated with ETNs. First, the technical explanation describes how ETNs ostensibly defer the tax consequences of current yield produced by the underlying indices, and characterizes those consequences as "materially more favorable to investors" than "traditional financial products" such as debt instruments, mutual fund shares, rolling short-term futures contracts, or direct ownership of securities reflected in an underlying index.[57]

The second issue raised by the technical explanation also involves the tax deferral associated with ETNs and focuses on the periodic rebalancing of the indices underlying ETNs. The technical explanation states that the rebalancing of ETNs indices also determines the yield on ETNs, in a manner similar to the rolling of short-term futures contracts or the rebalancing of a securities portfolio held by an investor, either directly or indirectly through an investment vehicle like a mutual fund. Gains and losses from rolling futures contracts or from rebalancing securities portfolios held by an investor generally are taxed on a current basis, while gains and losses from the rebalancing of ETNs indices are not taxed currently but, instead, are taxed cumulatively only when the ETN is disposed or matures.[58]

Without addressing whether the many legal and structural differences between ETNs and the other financial products mentioned justify the more favorable tax treatment of ETNs, the technical explanation states that these "fundamental problems" are compounded by the potential for prolonged deferral (as determined by the maturities of the ETNs) without any loss of liquidity (since ETNs can be redeemed at the option of the investor or readily traded on an exchange by the investor).

A. Overview of H.R. 4912

H.R. 4912 would add a new section 1289 to the code. The centerpiece of the legislation is the abandonment of pure open transaction treatment of prepaid forward contracts, which would be replaced by a general requirement that "holders"[59] of prepaid derivative contracts accrue income on these contracts. The holder's basis in the contract would be increased by the income accruals so as to offset any gain (or augment any loss) on disposition or maturity of the contract, and any loss recognized on disposition of the contract would be treated as an ordinary loss to the extent of previous basis increases resulting from the income accruals.[60] The legislation would not apply to any contracts that are marked to market for tax purposes, such as dealer contracts subject to section 475 or section 1256 contracts.[61]

For each tax year (or portion thereof) that the holder retains the contract, the amount of income accrual would be determined by multiplying the applicable monthly federal short-term rate by the holder's adjusted basis (that is, the holder's original basis as increased by previous income accruals). These income accruals would be treated as interest and are referred to in the legislation as "interest accrual amounts." If the holder is credited with notional amounts under the contract and the rate at which those amounts are credited exceeds the applicable monthly federal short-term rate, the interest accrual amounts would be determined by multiplying the holder's adjusted basis in the contract by the rate at which the notional amounts are credited (rather than the applicable monthly federal short-term rate).[62]

If distributions are made to the holder of a prepaid derivative contract, the distributions would not be included in gross income but would reduce the holder's basis in the contract. If the distributions exceed the holder's basis in the contract, the excess would be treated as gain from the sale of the contract.

In the case of publicly traded contracts (which are not actually marked to market for tax purposes), the interest accrual amount would be limited to the increase (if any) in the fair market value during the tax year (or the portion of the tax year during which the holder retains the contract), less any distributions made to the holder during the tax year. After applying this limitation, any excess interest accrual amount would be carried forward into the subsequent tax year. The holder's adjusted basis in a publicly traded contract would be determined without regard to this limitation, so the basis increase for a particular tax year would reflect the full interest accrual amount for that tax year, including any amount that exceeds the limitation and is carried forward to the subsequent tax year.

The breadth of H.R. 4912 is reflected in its definition of a "prepaid derivative contract," which includes any prepaid contract with a term of more than one year and which is a derivative financial instrument with respect to

[57]*See also* JCX-21-08, *supra* note 4, at 29 ("Treatment of the Dogs of the Dow Security as a prepaid contract produces very different tax results for the investor than investment in the underlying portfolio. An actual investment would result in current annual inclusions of both ordinary dividend income and capital gain, while synthetic ownership of the portfolio through the Dogs of the Dow Security defers income recognition to maturity and effectively converts ordinary dividend income to long-term capital gain.")

[58]*See also id.* at 29-30.

[59]Although both parties to a derivative contract generally can be considered "holders" of the contract, the legislation presumably applies only to the holder with the long position (that is, the holder making the prepayment) since it requires the accrual of income but not corresponding deductions.

[60]Thus, as JCX-21-08 elaborates, "if a holder has a loss from the disposition of a prepaid derivative contract, the loss is treated as an ordinary loss to the extent it does not exceed the amount by which the holder's basis in the contract has increased as a result of prior inclusions of interest accrual amounts." *See id.* at 33.

[61]In contrast, JCX-21-08, *supra* note 4, sets forth the mark-to-market method as one of the alternatives for the treatment of prepaid forward contracts.

[62]On this point, JCX-21-08, *supra* note 4, explains that, "for example, if the return on a prepaid contract reflects the return that would be derived from an unleveraged investment in futures contracts on physical commodities plus the interest that would be earned if cash collateral were invested in Treasury bills, and the interest rate on the Treasury bills is higher than the applicable Federal short-term rate, the interest accrual amount is determined by using the Treasury bill rate." *See id.* at 32 n.52.

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any security (as defined in section 475(c)(2)) or group of securities,[63] commodity or group of commodities,[64] or any financial index. A prepaid contract is defined to include any contract under which there is "no substantial likelihood" that the holder will be required to pay any additional amount under the contract beyond the initial prepayment. In addition to stock, debt, and partnership interests, a prepaid derivative contract would not include any instrument that is treated as a hedging transaction, a notional principal contract, an option, or part of a constructive ownership transaction to which section 1260 applies. In short, a prepaid derivative contract would consist of any forward contract (to which section 1260 does not apply) that is a prepaid contract and is not part of a hedging transaction.

B. General Observations on H.R. 4912

1. Asymmetry and interest income characterization. Aside from the overall change to the tax consequences of prepaid forward contracts, perhaps the most striking features of H.R. 4912 are the asymmetrical treatment of the counterparties to a contract and the characterization of the income accruals as interest. The fact that H.R. 4912 applies to holders of a long position — but not holders of the short position — in a prepaid forward contract is difficult to understand as a policy matter, while the treatment of the income accruals as interest can be justified by the view that the prepayment is really a loan, but leaves some unanswered questions about the overall nature of the contract.

In some respects, the lack of symmetry between counterparties likely is more of a theoretical point than a practical issue because virtually all ETNs are marked to market under section 475 by the issuing financial institutions so that, even if H.R. 4912 were to apply symmetrically to both of the counterparties, the exception provided for contracts that are being marked to market probably would preclude the application of the legislation to the issuers. Nevertheless, consistency (even if only in theory) would seem to suggest that the party receiving the prepayment (that is, the party with the short position) should accrue corresponding deductions if the appropriate tax policy for the party making the prepayment (that is, the party with the long position) is to accrue income. Furthermore, there is no reason that mark-to-market tax accounting and income accrual cannot coexist on a single financial instrument because mark-to-market tax accounting and the accrual of income are not mutually exclusive.[65] Therefore, the exception for contracts that are being marked to market should be eliminated from H.R. 4912, and the legislation should apply symmetrically to both parties to a contract.

It is not clear why the legislation does not provide for symmetrical treatment of the counterparties, although it may be the case that the bill is intended to raise tax revenues and it is believed that this would not occur if the legislation provided for accruals of deductions that generally would correspond to the income accruals. As currently drafted, the most likely impact of the legislation would be to push the market for prepaid forward contracts either offshore or into alternative investments with similar tax consequences under current law. Therefore, it is difficult to imagine any significant additional tax revenues actually being extracted from taxpayers who would be required to accrue taxable income under the bill. In any case, the asymmetrical tax treatment of counterparties certainly diminishes the tax policy merits of this legislation.

In addition to the asymmetrical tax treatment of the parties to a prepaid forward contract, the treatment of income accruals as interest under H.R. 4912 also is notable and would carry several tax consequences,[66] not the least of which are the tax compliance benefits of subjecting the income accruals to the information reporting regime already in place for interest.[67] That may be particularly important in the context of financial products like ETNs that may be marketed to retail customers who might not necessarily remember to include on their tax returns phantom income such as the income accruals that would be produced by this legislation.

However, perhaps the more interesting aspect of treating the income accruals as interest is that H.R. 4912 does not explicitly follow through on this characterization by expressly treating the contracts (or the prepayment component) to which it would apply as indebtedness. Even in the absence of a specific declaration that the contracts are loans, it could be argued that the contracts would be debt instruments for tax purposes simply by virtue of characterizing the income accruals as interest and the fact that the only source of interest is a debt instrument. On the other hand, the characterization of an item of income (or

[63]A security would be defined by reference to section 475(c)(2) (other than hedges that are treated as securities under section 475(c)(2)(F)), which includes corporate stock, interests in publicly traded or widely held partnerships, debt instruments, financial notional principal contracts, or interests (including derivative interests) in any of the above or in any currency.

[64]A commodity would be defined by reference to section 475(e)(2) (other than hedges that are treated as commodities under section 475(e)(2)(D)), which includes commodities that are actively traded (as defined in section 1092(d)(1)), notional principal contracts with respect to those commodities, or interests (including derivative interests) in those commodities or notional principal contracts with respect to those commodities.

[65]For example, section 475 does not exclude from its application debt instruments or notional principal contracts with nonperiodic payments.

[66]JCX-21-08, *supra* note 4, explains the rationale for interest accrual as follows: "In the case of a mandatory convertible security, this interest accrual approach effectively accepts the characterization of the security as an indivisible prepaid forward contract, which is the view adopted by issuers of those notes under present law. H.R. 4912 also reflects the view, however, that the treatment of a prepaid forward contract under present law does not adequately reflect the underlying economics of that contract. In particular, a prepaid forward contract may be understood as a traditional forward contract in respect of which the forward buyer has posted 100 percent of the purchase price as collateral, on which the forward seller in turn is required to pay interest." *Id.* at 33.

[67]Section 6049.

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expense) as interest normally is dictated by the characterization of the accompanying financial instrument as indebtedness (not the other way around), so the treatment of prepaid forward contracts as debt instruments cannot be assumed to flow from a statutory construct that requires income accruals on the contracts and labels those accruals as interest. To do so would be to ignore the fundamental reason why prepaid forward contracts have not been treated as debt instruments — the holder making a prepayment under a forward contract does not receive an unconditional promise from the counterparty to pay a sum certain on expiration of the contract.[68] Moreover, H.R. 4912 specifically excludes debt instruments from its application, which virtually requires that contracts subject to the legislation not be recharacterized as debt instruments to avoid internal contradictions in the interpretation of the legislation.

The question of whether contracts subject to the legislation would be treated as debt instruments has particular significance for cross-border transactions in which the holder of the long position is a foreign individual or entity. For instance, a 30 percent withholding tax generally is applied by statute to "fixed or determinable annual or periodical" income (including all interest) paid from U.S. sources to foreign individuals and entities.[69] An exception to the withholding tax generally applies to interest paid on certain debt instruments,[70] although that exception generally does not apply to contingent interest.[71] Therefore, interest paid by a U.S. issuer is considered to be U.S. sourced but exempt from statutory withholding tax. Meanwhile, income from forward contracts with a U.S. counterparty (including prepaid forward contracts) is not subject to U.S. withholding tax because it is treated as foreign sourced.

Because the statutory withholding tax presumptively applies to all interest, H.R. 4912 could have the effect of converting gain on a prepaid forward contract that currently is not subject to the withholding tax (because it is foreign sourced) into income that is subject to the withholding tax as it accrues, although that result is far from clear. While the actual economic return on ETNs and other similar prepaid forward contracts is entirely speculative, the interest income accruals that would be required under H.R. 4912 are not contingent, so the portfolio interest exemption presumably would not be precluded from applying to these accruals by the exception for contingent interest.[72] However, the portfolio interest exemption applies only to interest paid on obligations,[73] meaning that the exemption would not seem to apply to interest income accruals under the legislation unless either the contract or the prepayment itself could be considered indebtedness (or at least an obligation, which is a broader term than indebtedness). Of course, this probably would be an issue of first impression since it does not appear that there has ever been another example of interest being paid or received on anything other than indebtedness.

2. Income imputation and accrual. The code and regulations are sprinkled with different interest imputation and accrual regimes that are designed to capture and accurately reflect for tax purposes a time value of money component imbedded in a financial transaction.[74] Each of these regimes is unique in its mechanics and applies to a specific type of transaction.[75] In requiring that interest be imputed and accrued on prepaid contracts, H.R. 4912 would not simply apply one of the interest imputation or accrual mechanisms already in place. Rather, the imputation and accrual of interest income, along with the accompanying basis increases, that are mandated by the legislation might be thought of as an entirely new interest imputation and accrual regime that consists of elements of other existing methods.[76] For instance, H.R. 4912 would largely eliminate the disparate tax treatment of prepaid contracts on the basis of whether they provide for periodic payments by requiring interest income accruals on what probably would be considered significant nonperiodic payments under the swap regulations.[77] However, significant differences would persist in the tax treatment of prepaid contracts based on whether they provided for periodic payments, including the manner in which interest income is accrued and whether those accruals result in basis increases.[78]

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[68]Such a promise generally is considered to be an indispensable element for a financial instrument to be characterized as indebtedness for tax purposes. *See, e.g.*, FSA 199940007, *Doc 1999-32427, 1999 TNT 196-50*. ("The presence of a sum certain payable at maturity is a sine qua non of debt treatment under the Code.")

[69]Sections 871(a)(1)(A) (nonresident alien individuals) and 881(a)(1) (foreign corporations). Of course, this analysis is based upon the statutory withholding provisions, which may (and usually do) differ from the rules that apply with respect to countries with which the United States has an income tax treaty in effect.

[70]Sections 871(h) (nonresident alien individuals) and 881(c) (foreign corporations).

[71]Sections 871(h)(4) (nonresident alien individuals) and 881(c)(4) (foreign corporations).

[72]On the other hand, because the legislation would treat any losses on disposition or expiration of the contract as ordinary to the extent of basis increases (that is, previous interest income accruals), the IRS could argue that the interest accruals really are contingent and, therefore, ineligible for the portfolio interest exemption.

[73]*See* sections 871(h)(2) and 881(c)(2) (defining interest that is eligible for the portfolio interest exemption as interest that is paid on certain registered and unregistered obligations).

[74]*See* Farber, *supra* note 7, at 656.

[75]*See* sections 483, 1274, and 7872.

[76]Of course, the conspicuous difference between the legislation and all of the existing interest imputation and accrual methods is that the latter generally are consistent in providing symmetrical interest income and expense imputation and accrual (that is, they are symmetrical), while the former is not (that is, it is asymmetrical by requiring interest income accruals but not interest expense accruals).

[77]Reg. section 1.446-3(g)(4). These regulations are discussed in more detail below.

[78]On the maturity of a prepaid contract, similarly significant differences would exist between H.R. 4912 and proposed regulations that recently were issued and would apply to notional principal contracts with contingent nonperiodic payments, which attempt to apply concepts from the noncontingent bond

(Footnote continued on next page.)

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The interest income accrual regime in H.R. 4912 also bears a close resemblance to the noncontingent bond method of interest accrual in the contingent payment debt instrument regulations.[79] Like the noncontingent bond method, H.R. 4912 would require the accrual of interest to reflect at least some portion of the expected yield on the prepaid contract and would provide upward basis adjustments in the contract for these accruals. However, the legislation would not incorporate fully all of the components of the noncontingent bond method, with some obvious differences being that the legislation would: (1) require accruals to be determined based on an applicable federal rate rather than on an estimation of the yield on the contract; (2) require accruals of compounded interest rather than at a constant yield; and (3) generally treat a gain on the disposition or termination of the contract as capital gain rather than treating the gain as additional ordinary interest income.

3. Likely impact of H.R. 4912. H.R. 4912 would usher in a sweeping change to the tax treatment of prepaid forward contracts by requiring income accruals on a financial instrument the return on which is largely speculative. This fairly significant shift away from income realization to income accrual might reduce the disparate tax treatment of some financial instruments, but might actually magnify the disparate tax treatment of others. Even when the disparities are reduced, they would not be eliminated entirely because the legislation would create an entirely new income imputation and accrual regime that would add to the number of regimes already in effect for various financial instruments.

VI. Current (and Future?) Taxation of ETNs

In the absence of a wholesale overhaul of the tax treatment of financial instruments, there is no perfect way to tax ETNs.[80] The ETN-offering materials themselves point to several alternative approaches to characterizing and taxing ETNs under current law, but conclude that the most appropriate tax treatment of ETNs is to tax them in the same manner as prepaid forward contracts, which means that the intended tax consequences of ETNs are dictated by the open transaction doctrine. As a result, ETNs generally do not produce taxable income to investors (in the absence of actual distributions) until they are disposed of through trading or redemption, at which time the ETNs produce capital gain or loss if they are held as capital assets.

As discussed above, the tax treatment of ETNs in particular and prepaid forward contracts more generally is under close scrutiny by Congress, Treasury, and the IRS. However, it is not entirely clear that the taxation of ETNs — either in isolation or as part of broader changes to the tax treatment of prepaid forward contracts — could be addressed without creating separate sets of rules for ETNs that are treated as debt instruments and those that are not. In any case, H.R. 4912 demonstrates that any effort to modify the tax consequences of either ETNs alone or all prepaid forward contracts will only create more discontinuities if the effort is not undertaken as part of a comprehensive reform of the overall taxation of financial instruments, particularly if the modification results in an entirely new tax regime that differs from those that already exist for economically similar financial instruments, as would be the case with H.R. 4912.

A. ETNs as Debt Instruments

If ETNs promised investors at least a minimum guaranteed return of their initial investment and otherwise exhibited the general indicia of debt,[81] ETNs could be treated as debt instruments for tax purposes, consistent with their financial accounting treatment.[82] Even if a significant portion of that principal amount was contingent, the contingent payment debt instrument regulations demonstrate that such a feature does not necessarily preclude debt instrument treatment.[83] Generally, a debt instrument is treated as a CPDI for tax purposes if the amount of a payment or payments of principal or interest under the instrument is unknown or indeterminable as of the issuance date.[84] If an ETN were to be treated as a debt instrument, it generally would be subject to the noncontingent bond method under the CPDI regulations because ETNs generally are issued for cash.[85] The noncontingent bond method would require the issuer (and investor) to accrue original issue discount deductions (and income) based on the comparable yield of (in most cases) a zero coupon bond, with any under- or overaccruals being accounted for on disposition or maturity of the instruments generally as additional OID (in

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method for CPDIs. Prop. reg. section 1.446-3(g)(6). These regulations are discussed in more detail below.

[79]Reg. section 1.1275-4(b). These regulations are discussed in more detail below.

[80]*See generally* JCX-21-08, *supra* note 4 (proposing several alternatives for taxation of prepaid forward contracts in general, including ETNs).

[81]Because ETNs are publicly traded, their typical long maturities of as many as 30 years cut in both directions when determining whether they should be characterized as debt for tax purposes. That an ETN has a long maturity but can be traded at any time during its term suggests that the holder has a higher level of certainty to receive back the initial investment (plus a market return), depending on the quality of the underlying assets. On the other hand, the long term of an instrument always has been indicative that the instrument is not a debt instrument because of the heightened level of risk and volatility to which the holder is subjected in the long run. As we conclude below, however, the term of an ETN — whether it be 30 years or 5 years — should not be a decisive factor in determining whether it is properly characterized as a debt instrument for tax purposes.

[82]Note that JCX-21-08, *supra* note 4, did not address prepaid forward contracts that can be treated under tax law as debt instruments.

[83]Reg. section 1.1275-4(b). *See also* Farber, *supra* note 7, at 679-680.

[84]Note that the regulations do not affirmatively define the term "contingent payment debt instrument" for this purpose; rather, the regulations define the term by reference to what is not a contingent payment debt instrument.

[85]*See generally* reg. section 1.1275-4(b). Even if an ETN is issued for property rather than cash, it still would be subject to the noncontingent bond method because it is publicly traded.

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the case of an underaccrual) or a reversal of previously accrued OID (in the case of an overaccrual).[86]

As it stands, the amount (if any) returned to ETN investors is almost entirely determined by the value of the index being tracked by the ETN, and the IRS has made it clear for several years now that an insufficient amount of noncontingent principal does preclude a financial instrument from being treated as a debt instrument for tax purposes.[87] Therefore, with the notable exception of ETNs governed by Rev. Rul. 2008-1 (that is, ETNs based on foreign currency exchange rates), it does not appear that most ETNs in their current form could be treated as debt instruments.

As discussed above, H.R. 4912 would require the imputation and accrual of interest income (but not deductions) on ETNs and virtually all other types of prepaid forward contracts using a method that is similar to (but with some significant differences from) the noncontingent bond method in the CPDI regulations. H.R. 4912 would not expressly characterize ETNs and prepaid forward contracts as debt instruments and, in fact, generally would not apply to debt instruments, which are specifically excluded in the bill.

Because the interest accrual method provided in H.R. 4912 would apply only to income and would differ in some important respects from the noncontingent bond method (and, for that matter, any other interest accrual methods in existence), current and future versions of ETNs could wind up toggling between differing interest accrual methods based on their characterization as debt instruments.[88] In this regard, perhaps the most likely and enduring consequence of enacting H.R. 4912 would be the creation of even more disparities in the taxation of financial instruments and additional opportunities for financial engineering tailored to the specific tax needs of investors.

B. ETNs as Nondebt Financial Instruments

Assuming that ETNs are not debt instruments for tax purposes — which certainly should be the case in the absence of any principal protection — ETNs could be characterized in several different ways. However, no characterization reflects the attributes of ETNs as precisely as that of prepaid forward contracts (with the possible exception of ETNs that track currency exchange rates, as described above in relation to Rev. Rul. 2008-1) because ETNs are simply long-dated exchange-traded versions of those contracts.

Specifically, the guidance set forth by the IRS in Rev. Rul. 2003-7 is most relevant in determining the appropriate tax consequences of nondebt ETNs, and the open transaction treatment of forward contracts also should apply to ETNs. The fact that ETNs are pegged to an index while many prepaid forward contracts are pegged to a single stock should not preclude ETNs and prepaid forward contracts from being treated similarly.

Nevertheless, it is worthwhile to briefly consider some of these alternative tax treatments of ETNs, and why they are inferior to treating ETNs as prepaid forward contracts. If nothing else, examining these alternatives demonstrates how potentially minor differences among financial instruments and their structures can yield very different tax consequences — and how H.R. 4912 likely would only exacerbate this situation by creating yet another method of taxing a particular financial instrument.

1. Notional principal contracts. A notional principal contract (colloquially referred to as a swap contract) is defined for tax purposes as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index on a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[89] Special rules have been proposed with regard to notional principal contracts that call for a contingent nonperiodic payment in return for a periodic payment from the counterparty.[90]

ETNs generally do not provide for actual distributions of current yield to investors but rather require only one payment by each of the counterparties (that is, the initial investment by the investor and the payment by the issuing bank based on the value of the underlying index at maturity). Therefore, ETNs should not be taxed as notional principal contracts because ETNs do not provide for periodic payments between the parties during the term of the contract, which generally is recognized as precluding an instrument from being considered a notional principal contract for tax purposes.[91]

If ETNs were treated as notional principal contracts, the prepayment made by the investor almost certainly would be considered a "significant nonperiodic payment," which would require the parties to treat the payment for all tax purposes as a loan separate and apart from the swap contract and accrue interest income and

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[86]*See id.*

[87]*See* FSA 199940007 and Notice 94-47, 1994-1 C.B. 357, *Doc 94-3984, 94 TNT 75-1.*

[88]In fact, JCX-21-08, *supra* note 4, specifically explains that the dividing line between instruments that should be subject to imputation and instruments that should not should be moved "to a point at which a time value of money return can be identified, even if the investor is at risk of losing not only that return but his principal amount." *Id.* at 33.

[89]Reg. section 1.446-3(c)(1)(i). *See also* JCX-21-08, *supra* note 4, at 9. ("A swap is an agreement between two parties to exchange sets of cash flows over a period of time.")

[90]Prop. reg. section 1.446-3(g)(6). Issued in 2004, these rules would introduce the noncontingent swap method, which is a very complicated version of the non-contingent bond method that applies to contingent payment debt instruments. For an overview and criticism of these proposed regulations, see Garlock, *supra* note 18.

[91]ETNs are similar to "bullet swaps," which practitioners have concluded and the IRS has suggested are not treated as notional principal contracts for tax purposes. *See* Notice 2001-44, 2001-2 C.B. 77, *Doc 2001-18296, 2001 TNT 129-2.* ("There may be little difference in economics between a [notional principal contract] as defined in [the notional principal contract regulations] and a series of bullet swaps, yet the payments made under one are covered by the regulation, whereas the payments under the other may not.")

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deductions on the payment.[92] Also, if ETNs are notional principal contracts, they probably would be subject to the rules that have been proposed for contingent nonperiodic payments, if adopted.

Beyond the fact that the rules for significant nonperiodic payments and the proposed rules for contingent nonperiodic payments apply (or would apply) to both counterparties (rather than applying only to the party making the payment), there are significant differences between those rules and the rules that would apply to contracts under H.R. 4912.[93] For example, the interest income accruals required for significant nonperiodic payments would not increase the investor's basis in the contract, while they would under H.R. 4912. Consequently, the enactment of H.R. 4912 likely would have the effect of creating an election between similar but different tax consequences that would apply on the basis of whether a contract provided one or more periodic payments that could have little economic significance.

2. Mark-to-market. As discussed above, virtually all ETNs are being marked to market under section 475 by the financial institutions that issue them.[94] Generally speaking, the retail investors in ETNs are not required (or, in fact, permitted unless they are traders) to mark their ETNs to market under current law.[95] Because ETNs are traded on public exchanges (as opposed to other types of prepaid forward contracts), their values are readily ascertainable, so valuation generally would not be an impediment to requiring investors to mark their ETNs to market.[96] Indeed, there has been some suggestion that the mark-to-market treatment of some contracts under section 1256 should be expanded to include ETNs.[97] Because section 1256 applies only to exchange-traded contracts, the statute offers a ready-made rationale for changing the tax treatment of ETNs without taking on the larger task of addressing the overall tax treatment of prepaid forward contracts, which are not publicly traded (beyond ETNs).

In addition to valuation, the other major constraint on adopting a mark-to-market method of accounting generally is liquidity to pay a mark-to-market tax liability.[98] This involves the question of whether the taxpayers most likely to be affected by mark-to-market tax accounting would have the resources to pay a tax on paper gains.[99] The liquidity issue would be particularly acute in the case of ETNs, which are tailored specifically to appeal to retail investors.[100] For these investors, the exposure to potentially unlimited tax liability would diminish the attractiveness of ETNs to the point that the imposition of mark-to-market tax treatment of ETNs likely would bring about the demise of the product.

Beyond the specific impact on ETNs as a viable financial product, imposing mark-to-market taxation on ETNs would have more profound implications. Marking ETNs to market would constitute another step in a gradual march toward expanding mark-to-market tax treatment of financial products that began more than a quarter-century ago with the enactment of section 1256 and has continued through subsequent expansions of the scope of section 1256 and the enactment of section 475.[101] However, this particular step would be significant because it probably would bring the tax system to the brink of a broad-based mark-to-market regime that would apply to a wide swath of taxpayers and common financial instruments. Such a step might be worth taking, but it should not be taken out of a narrow concern about the tax advantages of a particular financial instrument. Rather, it should be taken as part of a comprehensive and systematic examination of the extent to which mark-to-market tax accounting could be expanded to all taxpayers and financial instruments for whom and for which the benefits of mark-to-market tax treatment outweigh valuation and liquidity concerns.

3. Tax ownership. Questions of tax ownership long have been problematic when they have involved securities and other financial instruments.[102] The basic tax ownership formula of evaluating the benefits and burdens of ownership still applies, but so many of the attributes typically associated with the tax ownership of tangible property (for example, physical possession) are unhelpful in determining what the holder of a financial instrument

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[92]Reg. section 1.446-3(g)(4).

[93]As with debt instruments, H.R. 4912 would not apply to notional principal contracts, so the rules provided in the bill would not override the rules applicable to notional principal contracts but, instead, would reside alongside the notional principal contract rules.

[94]Under section 475(a), all securities (including derivatives) held by a dealer are marked to market unless they are specifically identified as being excluded from mark-to-market treatment.

[95]*See* JCX-21-08, *supra* note 4, at 31-32 (discussing the possibility of marking prepaid forward contracts to market).

[96]*See id.* at 32. ("Many mandatory convertible securities may not have a readily ascertainable fair market value, e.g., where they are not actively traded on an exchange. Determining a value at which to mark the securities to market each year could present challenges for both taxpayers and the IRS in those circumstances.")

[97]Section 1256(a) provides the basic tax consequences applicable to the acquisition and holding of a position that qualifies as a "section 1256 contract." Under this provision, each section 1256 contract held by a taxpayer at the close of the tax year is marked to market on the last business day of each tax year, and any gain or loss is then taken into account.

[98]*See* JCX-21-08, *supra* note 4, at 32. *See also* David J. Shakow, "Taxation Without Realization: A Proposal For Accrual Taxation," 134 *U. Pa. L. Rev.* 1111, 1167 (1986). ("After valuation, the second major obstacle to adopting an accrual tax system is taxpayer illiquidity: should the tax system require a person to pay a tax on the appreciation of an asset when the tax may require the person to sell the asset?")

[99]*Id.*

[100]Deborah Schenk, "A Positive Account of the Realization Rule," 57 *Tax L. Rev.*, 355, 360-362 (2004) (arguing that the liquidity argument is no longer a problem but, politically, mark-to-market is not feasible).

[101]*See generally* Yoram Keinan, "Book-Tax Conformity for Financial Instruments," 6 *Fla. Tax Rev.* 678 (2004).

[102]*See generally Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981).

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actually owns.[103] The economic relationships that are represented by financial instruments can be altered or synthesized in a seemingly infinite variety of ways. Therefore, the tax ownership distinction that often takes center stage when considering financial instruments — the risk of loss and opportunity for gain — often is a matter of degree, not kind. This makes the tax ownership inquiry that typically is most relevant to financial instruments also the most impotent in determining what (if any) tax ownership comes with holding a particular financial instrument.

The profound difficulties involved in making this determination can be seen in the limited statutory attempts that Congress has made to prescribe tax consequences based on notions of tax ownership (or the existence or absence of a change in tax ownership) in specific situations.[104] In many cases, these statutory provisions were enacted to arrest the outbreak of a particular financial transaction that captured the attention of policymakers. However, over time they have tended to be ineffective at keeping pace with evolving markets, leaving the IRS and Treasury with the difficult dilemma of deciding whether and how to apply these provisions to subsequent variations and generations of the transactions initially targeted by Congress.[105]

Prepaid forward contracts generally result in a transfer of the risk of loss and opportunity for gain, but this has not been viewed as automatically transferring tax ownership in the underlying securities.[106] Regarding ETNs, while the investor does acquire the risk of loss and opportunity for gain from the underlying investments, an ETN is a bare contract that does not entitle the investor to acquire a direct interest in the underlying investments or exercise any control over these investments (for example, voting rights in equities). Therefore, the absence of any other characteristics of tax ownership would appear to overcome the notion that the tax consequences of ETN investors should reflect a direct interest in the underlying investments under general tax ownership principles.[107] H.R. 4912 does not purport to effect a change in tax ownership resulting from entering into a prepaid forward contract. Indeed, the tax consequences that would be prescribed by H.R. 4912 for prepaid forward contracts do not reflect those that would arise from treating prepaid forward contracts as changing the tax ownership of the underlying securities. Therefore, it is unlikely that the legislation would further complicate the already thorny questions surrounding tax ownership and financial instruments.

VII. Conclusion

With the growing interest in prepaid forward contracts in general, and ETNs in particular, a more comprehensive and intensive examination of the appropriate tax consequences of prepaid forward contracts by Treasury (and the IRS) and Congress is well underway. Of course, any review and reconsideration of the existing guidance on prepaid forward contracts by Treasury and the IRS can be expected to directly affect the market for ETNs. Ideally, any new guidance would at least follow the lead of H.R. 4912 by leaving the treatment of any ETNs that are properly treated as debt instruments to the CPDI regulations (or, in the case of currency exchange rate ETNs, to section 988 and the regulations thereunder, as provided in Rev. Rul. 2008-1). Only time will tell whether the wait-and-see realization approach to prepaid forward contracts provided by Rev. Rul. 2003-7 will survive the current round of scrutiny.

More broadly, the story of financial products taxation far too often has been one of policymakers reaping the bitter fruits of rules they have sown in response to the latest financial instrument or transaction that promises a particular tax advantage. In this case, after years of taxpayers seeking interest accrual deductions with financial instruments designed to be treated as debt for tax purposes — and the IRS predictably resisting these efforts in most cases — ETNs apparently have turned the tables as a product that is wrapped as a debt instrument but is marketed as having the same tax consequences as those of prepaid forward contracts.

The financial products that raise the most difficult and uncomfortable issues generally are not those that promise to improve the investor's overall tax position by, say, generating artificial losses or deductions. Rather, they are the financial instruments that resemble the economics, but not the tax consequences, of other financial instruments. Prepaid forward contracts in general, and ETNs in particular, fall into this latter category.

Putting aside questions about why the tax treatment of prepaid forward contracts has become controversial only now that these contracts have become available to retail investors, ETNs once again present to policymakers the fork in the financial products tax road between an overhaul of our system of taxing financial instruments and the well-traveled path towards the law of unintended consequences. As broad as H.R. 4912 may seem in its general application to prepaid forward contracts rather than merely ETNs, it still is narrowly targeted in relation to the overall scope of the problems with the incongruous treatment of economically equivalent financial products. Not only are ETNs similar to mutual fund shares as an investment product (at least on a pretax basis), but prepaid forward contracts in general can be very similar to direct equity ownership, debt, or notional principal contracts, not to mention an array of synthetic

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[103] *Id.* For an insightful description and analysis of the problems with applying traditional notions of tax ownership to financial instruments, see Edward D. Kleinbard, "Risky and Riskless Positions in Securities," 71 *TAXES* 783 (Dec. 1993).

[104] *See, e.g.*, sections 1058 (securities lending agreements), 1259 (constructive sales), and 1260 (constructive ownership).

[105] *See, e.g.*, Rev. Rul 2003-7 (discussing tax ownership issues that pertain to prepaid forward contracts). Nevertheless, when the IRS learned about prepaid forward contracts accompanied with share loans, it conducted a thorough tax ownership analysis to conclude that passage of ownership of the underlying shares had occurred, as discussed above. *See, e.g.*, TAM 200604033.

[106] *Id. See* TAM 200604033 (Rev. Rul. 2003-7 does not apply to variable prepaid forward contracts together with share loans).

[107] While JCX-21-08, *supra* note 4, discusses the tax benefits of structuring the transaction as a forward contract as opposed to actual ownership of the actual stock, it does not assert that prepaid forward contracts (including ETNs) should be recharacterized as constructive ownership transactions.

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financial instruments. Changing the tax treatment of prepaid forward contracts on account of a perceived competitive advantage of ETNs over mutual fund shares will not alleviate all of these other incongruities and actually could create new ones if an entirely new tax regime is created for prepaid forward contracts. As is the case all too often in the world of financial products, the cure could be worse than the disease.

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