



An Intelligent Response to the Challenges to Prepaid Variable Forwards

PVFs have been the subject of a series of IRS challenges in the United States, including the most recent Anschutz decision. Investors can use the new portfolio margining rules under Regulation T (Reg T) to achieve the same desirable results as a PVF while eliminating both the tax and audit risk associated with a PVF.

Managing the risk of concentrated positions in publicly traded stock is one of the most important services that wealth managers perform on behalf of their ultra-high-net-worth clients. In the United States since 1997, when the constructive sales rules were enacted by Congress, the primary mechanism that advisers have relied on to hedge and monetize a highly appreciated stock position while deferring the capital gains tax has been a derivatives tool known as a prepaid variable forward (PVF) sale agreement.

When using a PVF an investor receives 75–90 percent of the value of shares in cash (depending on the stock and the maturity) in exchange for a commitment to sell a variable amount of shares in the future depending on the stock's price at that time. If the stock increases above a fixed price, the investor is obligated to sell the shares at that fixed price (limiting the upside). If the stock decreases below a specified floor value, the investor sells enough shares at the fixed price to provide this floor, thus achieving the same pretax economics as the equity collar.

ANSCHUTZ DECISION RENDERED

On 22 July 2010, in a long awaited but not unexpected decision, the U.S. Tax Court dealt another blow to PVF sale contracts. In *Anschutz Co. et al. v. Commissioner* (135 T.C. No.5), the Tax Court held that entering into a PVF triggered an immediate taxable event because the investor made shares available for the dealer to borrow through a separate securities lending agreement in order to facilitate the dealer's hedge. The court looked at the PVF and share

loan as one agreement rather than two separate agreements and concluded that the arrangement should be characterized as a current sale requiring gain recognition on the upfront cash proceeds received by the investor. The Anschutz decision was the first ever on a PVF. The Anschutz Co. has indicated that it intends to “vigorously appeal” the adverse ruling.

MCCOMBS CASE FILED

A few days later, on 27 July 2010, Forbes reported that the IRS is demanding \$45 million in back taxes from San Antonio billionaire Billy Joe “Red” McCombs. McCombs entered into a PVF with J.P. Morgan in 2002 covering 11.3 million shares of Clear Channel Communications and also lent 11.3 million shares to the bank that same year. In a lawsuit filed in May in U.S. Tax Court, McCombs is contesting the IRS's assertion that he should have reported \$213 million of long-term capital gains in 2002 from the sale of 11.3 million shares of Clear Channel Communications.

FOUR PRIOR CHALLENGES

In addition, the IRS has previously challenged the tax treatment of PVFs in four separate cases dating back to 2001, 2006, 2007, and 2008. In each of these cases, the IRS released an accompanying memorandum concluding that the PVF was a “common law sale” triggering an immediate taxable event because the investor did not retain sufficient “incidents of ownership” with respect to the hedged shares. Furthermore, the IRS has directed its

agents to audit taxpayers who execute PVFs, has suggested that PVFs might constitute “tax shelters,” and has identified a litany of potential penalties that apply if a PVF is, in fact, deemed a tax shelter.

IMPLICATIONS FOR THE FUTURE

Although it is certainly not good news for investors that another PVF was successfully challenged, collectively, these “case studies” can give investors and their advisers some guidance as to what it might take to structure PVFs to withstand attack by the IRS in the future. For instance, it seems absolutely clear that an investor who enters into a PVF should not make his or her shares available for the dealer to borrow because the IRS views a PVF and a separate share lending agreement as a single contract triggering an immediate sale. Currently, the consensus view among tax and wealth advisers is that, if a PVF is structured properly, it should withstand scrutiny.

LATENT TAX RISK

However, even if a PVF is structured conservatively from a tax perspective, some degree of tax uncertainty will remain because its legal form is that of a “sale,” a fact that should give investors and advisers pause.

The PVF is a classic case of “regulatory/tax arbitrage” that gives the PVF a less than perfectly solid foundation. The IRS and government regulators typically bristle when they are aware such regulatory/tax arbitrage is occurring and often take action to eliminate it. For instance, the recently passed Dodd–Frank Act severely limits bank holding companies from using “trust preferred securities” in a way that would simultaneously treat them as debt for tax purposes (with interest payments being tax deductible) and Tier 1 equity capital for regulatory purposes.

In a similar vein, a PVF is structured as a sale for regulatory purposes but not for tax purposes. One of the basic tenets of U.S. tax law is that form generally controls over substance, and a PVF has the legal form of a sale. The documentation clearly labels and refers to the transaction as a sale, and a PVF is, in fact, treated as a sale for regulatory purposes. As a result, the margin rules do not apply, and there are no limitations on the use of the cash proceeds that are released to the investor. In direct contrast, for tax purposes, a PVF is not supposed to be an immediate sale. It is certainly not outside the realm of possibility that this line of reasoning could form the basis for future challenges against PVFs.

Therefore, it would seem prudent for investors and advisers to use a strategy that does not have the legal form of a “sale” and was not designed to permit regulatory/tax arbitrage.

USING THE NEW PORTFOLIO MARGINING RULES

Investors can use the new “portfolio margining” rules under Regulation T (Reg T) to achieve the same desirable results as a PVF while eliminating both the tax and audit risk associated with a PVF. The investor is not using a strategy that has the legal form of a sale. Rather, the investor enters into two separate and distinct transactions—a hedging transaction, such as an options-based collar, and a subsequent borrowing transaction extended under the new portfolio margining rules of Reg T.

This technique allows for the same or greater monetization as a PVF. The borrowed proceeds can exceed 90 percent of the value of the hedged position. Furthermore, exactly like a PVF, there are no limitations on the use of proceeds, including investments in publicly traded stocks. That is, the purpose/nonpurpose limitations and the 50 percent margin requirements of Reg T do not apply, which is the primary reason why investors have used PVFs.

In certain cases, this technique delivers a superior tax result to that of a PVF. And in some situations, counterparty credit risk can be greatly mitigated.

CONCLUSION

The prudent management of single-stock risk is critically important and exceedingly complex. For those investors and advisers seeking an alternative to PVFs because of the continuing onslaught of challenges, the new portfolio margining rules can be used to achieve the same attractive results that the PVF was designed to deliver (hedging, monetization, and tax deferral) but absent the same degree of tax and audit risk posed by PVFs.

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