US Tax
Morrison & Foerster LLP

Prepaid forward plus stock loan case

On July 22 2010, the US Tax Court ruled against the taxpayer in Anschutz v Commissioner (135 T.C. No. 5), the widely-followed US prepaid forward plus stock loan case.

In 2000 and 2001, Anschutz entered into a prepaid variable forward contract (PVFC) plus share loan with Donaldson, Lufkin & Jenrette (DLJ). Simplifying the transactions at issue in the case, Anschutz entered into a master stock purchase agreement (MSPA) with DLJ to sell DLJ a variable number of shares of Union Pacific Resources Group and Anadarko Petroleum common stock in ten years. In exchange, Anschutz received 75% of the stock's initial fair market value upon executing the transaction. The PVFCs provided for delivery of a variable number of shares or cash depending on the share price at settlement. As such, Anschutz transferred all the downside risk to DLJ, kept the first 50% of the stock's appreciation and any appreciation above that accrued to DLJ. Anschutz was required to pledge the underlying shares as collateral under the MSPA. The shares were pledged pursuant to a "Pledge Agreement" to a collateral agent. The Pledge Agreement also provided that the collateral agent would enter into a stock lending agreement (SLA) with DLJ. The SLA permitted DLJ to borrow the shares held in the collateral account at any time and to pay a 5% fee to Anschutz if it did so. DLJ, in fact, borrowed the shares immediately when the transactions were entered into. Anschutz argued that the MSPA and the SLA should be considered separate transactions for federal income tax purposes and therefore that the MSPA was not a sale for federal income tax purposes under the authority of an IRS published ruling which holds that a vanilla PVFC does not result in either an actual sale or constructive sale for federal income tax purposes.

Tax court decision

Tax Court Judge Joseph Robert Goeke held that the transaction resulted in a sale for federal income tax purposes. Most importantly, without citing a discernible legal standard, the decision held that the MSPA and SLA should be viewed as one integrated transaction for federal income tax purposes. The Court stated that "the two legs were clearly related and interdependent, and both were governed by the MSPA." The Court observed that while Anshutz could recall the shares under the SLAs at any time, DLJ could accelerate the PVFCs if, among other things, it was unable to hedge its position. This was cited as evidence the two agreements should be integrated. The Court also found that lending the shares subject to the PVFCs was a "vital part" of the transaction, and that immediate borrowing of Anschutz's shares by DLJ to cover its market short sales was contemplated during the parties' negotiations. Upon finding that the MSPA and the SLA were one integrated transaction, Judge Goeke then analysed the overall transaction under a multifactor test. Viewing the SLA and the MSPA together, the Court held that Anschutz had transferred legal title, the entire risk of loss, a major portion of the opportunity for gain, the right to vote the stock and possession of the stock. Accordingly, the Court found Anschutz had sold the stock for federal income tax purposes.

The Tax Court determined Anschutz's amount realized on the transaction to equal the amount of cash received excluding, however, the value of the derivative giving Anschutz the right to future upside in the stock since that derivative might never result in cash received. This was roughly 80% of the value of the share position – the 75% prepayment on the PVFC and the 5% SLA fee.

Importantly, the Court did accept the conclusions of the prior IRS published ruling which holds that a straight PVFC does not result in a sale or constructive sale for federal income tax purposes if certain requirements are met. That should mean that PVFCs, without share lending agreements, can still be safely executed by US taxpayers.

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