The Red and the Black
A Very Brief Treatise on the Taxation of Structured Notes



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THE RED AND THE BLACK: A VERY BRIEF TREATISE ON THE TAXATION OF STRUCTURED NOTES

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"Their vagueness was unlimited . . . ."[1]

I. INTRODUCTION

Very generally, a structured note is a prepaid contract issued by a bank to an investor that consists of a debt instrument stapled to a derivative[2] contract that pays a return linked to an underlying referent (a "Reference Asset")—*i.e.*, a specific asset, basket of assets, or index.[3] The global structured notes[4] market is valued at approximately $2 trillion dollars.[5] Surprisingly, given the size of this asset class, there is relatively little tax commentary on the taxation of structured notes.[6] Moreover, only a handful of tax practitioners are fortunate enough to advise on the taxation of structured notes, and this corner of the tax world is as deeply steeped in law as it is in lore. This article provides a glimpse into the exciting and challenging world of structured notes taxation. This Part I provides some background on structured notes. Part II discusses how tax practitioners

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[1] STENDHAL, THE RED AND THE BLACK (Roger Gard, trans., Penguin Classics 1st ed. 2002) (1830).

[2] The Joint Committee on Taxation (the "JCT") has provided a helpful definition of "derivative," which is relevant here:

> A "derivative" is a bilateral (two-party) executory contract (a contract under which either or both parties must perform in the future, by delivering property or money) with a limited term (lifespan), the value of which is determined by reference to the price of one or more fungible securities, commodities, rates (such as interest rates), or currencies (an "underlier").

Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Derivatives* (JCX-21-08), at 2 (Mar. 4, 2008) [hereinafter JCT Report].

[3] Although structured notes can (and often do) reference multiple Reference Assets, this paper—except where noted otherwise—generally refers to Reference Asset in the singular. Moreover, a structured note may be linked to an underlying referent that could be difficult to categorize as an "asset" (such as an index based on interest rates or consumer prices). This paper is complex enough; for simplicity, "Reference Asset" should be read as encompassing any underlying referent.

[4] This paper refers to "structured notes," but the instruments discussed herein may be issued in the form of notes, certificates, warrants, or may have other designations. Technically, "structured products" could be a better term for the instruments discussed in this paper.

[5] Structured Notes 101 – Infographic, https://haloinvesting.com/structured-notes-infographic/ (last visited Sept. 1, 2025).

[6] The author is aware of only a handful of articles that focus specifically on the taxation of structured notes; the most recent of these articles is 13 years old as of the publication of this paper. The most comprehensive article on the taxation of structured notes is Michael S. Farber, *Equity, Debt, NOT – The Tax Treatment of Non-Debt Open Transactions*, 60 TAX LAW. 635 (2007). *See also* Omri Y. Marian & Andrew D. Moin, *Taxation of Structured Debt in a Low-Rate Environment*, 135 TAX NOTES 323 (2012); Paul Kunkel, *Reverse Convertibles*, 7 J. TAX'N FIN. PRODS. 15 (2008); Sam Dimon, *What Are They, Again? Foreign Currency Questions from the World of Structured Notes*, TAX CLUB (Apr. 13, 2011); Robert S. Bernstein, *Recent Developments in Structured Notes*, 33 J. CORP. TAX'N 28 (2006). There are also several articles that mention structured notes, but do not focus specifically on them. *See, e.g.*, Jeffrey D. Hochberg & Michael Orchowski, *What Looks the Same May Not Be the Same: The Tax Treatment of Securities Reopenings*, 67 TAX LAW. 143, 178–183 (2013). There are also several articles that discuss exchange-traded notes, which are essentially publicly-traded structured notes and which raise similar tax issues. *See, e.g.*, Ray Beeman & Yoram Keinan, *The Tax Treatment of Exchange-Traded Notes: Here We Go Again*, 119 TAX NOTES 485 (May 5, 2008).

generally characterize structured notes for U.S. federal income tax purposes. Finally, Part III discusses some common issues presented by structured notes.[7]

Structured notes generally are financial instruments that are unsecured, rank *pari passu* with the issuer's senior debt and are issued from an issuer's registered "shelf."[8] Registered structured notes are initially offered to purchasers through a preliminary pricing supplement with tentative terms (the "red") followed by a final pricing supplement with definitive terms (the "black"). Most structured note issuers are highly-creditworthy and well-capitalized banks. These issuers account for their outstanding structured notes on a mark-to-market basis for both financial accounting purposes (under A.S.C. 815) and tax purposes (under Code Sec. 475).[9]

Structured notes can include varying economic features—*e.g.*, a minimum guaranteed return of capital (*i.e.*, "principal protection"), a fixed or contingent coupon, a buffer that permits the underlying Reference Asset to decline by a certain amount before the investor loses principal, "long" or "short" exposure to the Reference Asset (or sometimes both), etc. The investing world generally divides structured notes into the following two mutually exclusive categories: "income" and "growth" notes. Income notes generally provide a potential return on investment in the form of a fixed or contingent coupon. The yields on income notes tend to be higher than bond yields or dividend yields. In return for these above-market yields, the investor may be required to assume the risk that it will not receive the coupon if the Reference Asset underperforms and/or assume some measure of downside risk—*i.e.*, the risk that the investor will lose some or all of its investment if the Reference Asset declines in value. Growth notes generally provide a potential return by allowing the investor to participate in upside—*i.e.*, the possibility that the investor will earn a return upon a maturity or early call of the structured note if the Reference Asset increases in value. Growth notes also expose the investor to downside risk. Both income notes and growth notes may provide the investor with some downside protection, such as a minimum guaranteed recovery of capital or a buffer.

Various types of investors, including domestic and foreign individuals and institutions, purchase structured notes. The U.S. federal income tax treatment of a structured note often determines which investors purchase it. For example, notes that the issuer believes may, at some level of comfort, result in the investor recognizing long-term capital gain at maturity generally

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[7] It would be extremely challenging to cover every U.S. tax issue, or even most of the U.S. tax issues, presented by structured notes. This paper does not discuss, *inter alia*, the application of the following regimes to structured notes: FATCA, Code Sec. 871(m), the tax information and backup withholding rules, and the "Medicare" tax of Code Sec. 1411. Among other things, those regimes generally do not apply to structured notes in a way that is particularly distinct from how they apply to other types of financial instruments.

[8] Some structured notes are issued under different securities law paradigms (*e.g.*, SEC Regulation S or Section 3(a)(2) of the Securities Act of 1933).

[9] The question of how these issuers apply mark-to-market tax accounting under Code Sec. 475 to structured notes treated as debt instruments for U.S. federal income tax purposes notwithstanding Treas. Reg. § 1.475(c)-2(a)(2)—which provides that a debt instrument issued by the taxpayer cannot be marked to market under Code Sec. 475—is a question for another day. *Cf.* John D. McDonald, Ira G. Kawaller, L.G. "Chip" Harter & Jeffrey P. Maydew, *The Devil is in the Details: Problems, Solutions and Policy Recommendations with Respect to Currency Translation, Transactions and Hedging*, 89 TAXES 199, 222 (2011) (arguing that Treas. Reg. § 1.475(c)-2(a)(2) should not apply to nonfunctional currency debt instruments).

represent an attractive investment for U.S. taxable individuals who benefit from the capital gains preference.[10] Growth notes often fall into this category. On the other hand, notes that give rise to significant ordinary income in the form of a fixed or contingent coupon, or "phantom" interest income (in the case of notes that are treated as contingent payment debt instruments), are less attractive to U.S. taxable individuals but may represent an appropriate investment for foreign or tax-exempt holders (*e.g.*, individual retirement accounts) that are not subject to U.S. federal income tax. Income notes generally fall into this category. Finally, if there is a significant risk that amounts payable with respect to a structured note could give rise to U.S. withholding taxes, the note will generally be marketed to U.S. investors only.

Registered structured notes generally include extensive U.S. tax disclosure. SEC Staff Legal Bulletin No. 19 states that it is the SEC's opinion that, when the tax consequences of a transaction are material to investors,[11] the offering materials must include a tax opinion that discloses the name of the relevant tax counsel.[12] Accordingly, the pricing supplement of a registered structured note generally will include a tax opinion that sets forth the likely U.S. tax characterization of the note (at some level of comfort) and the attendant U.S. tax consequences for holders. Generally, the disclosure provided in the note-specific pricing supplement will direct investors to also review the more general U.S. tax disclosure set forth in a "product supplement" and/or "prospectus supplement" applicable to a broader range of notes. The combination of deal-level and program disclosure generally sets forth the U.S. tax consequences for both holders that are "United States persons," as defined for U.S. tax purposes ("U.S. Holders"), and holders that are not United States persons ("Non-U.S. Holders").[13] Generally, the disclosure will make certain assumptions about holders—*e.g.*, that a U.S. Holder holds the structured note as a capital asset or that the holder does not have a particular status that could affect its tax consequences (such as being a dealer in securities or a partnership, holding the structured note as part of a straddle, using a functional currency other than USD, etc.).

II. THE CHARACTERIZATION OF STRUCTURED NOTES

a. Overview

In attempting to divine the U.S. tax consequences of a structured note, the first and most important question is how to characterize the note for U.S. federal income tax purposes. This Part II discusses the law and lore that inform that inquiry.

There is very little authority on the characterization of structured notes. As Professor Weisbach said, "[t]he tax law generally approaches financial products through a category or

[10] *See* Code Sec. 1(h).

[11] *See also* Regulation S-K, 7 C.F.R. § 229.601(b)(8).

[12] *See* SEC Staff Legal Bulletin No. 19 at ¶ III (Oct. 4, 2011).

[13] Disclosure materials generally provide that, in addition to non-"United States persons" (as defined for U.S. tax purposes), the following persons generally are *not* considered to be Non-U.S. Holders: (i) individuals present in the United States for 183 days or more in the taxable year of disposition of a structured note that are not otherwise a residents of the United States for U.S. federal income tax purposes and (ii) former citizens or residents of the United States that meet certain conditions.

'cubbyhole' system. For example, the tax law prescribes separate rules for stock, debt, options, forwards, futures, swaps, and other instruments."[14] In the absence of direct authority on how to characterize a transaction or instrument, tax practitioners, courts, and the Internal Revenue Service (the "IRS") generally examine the tax treatment of analogous transactions or instruments.[15] However, as Professor Weisbach cautions, "the cubbyhole system is difficult to apply by analogy because an instrument can have characteristics of a variety of instruments that fit into disparate cubbyholes. Thus, parties who wish to create a new instrument may be faced with substantial tax uncertainty."[16]

Accordingly, in many cases, the tax disclosure for a structured notes issuance will include a statement along the following lines:

> The tax consequences of an investment in the notes are unclear. There is no direct legal authority as to the proper U.S. federal income tax treatment of the notes, and the issuer does not intend to request a ruling from the IRS regarding the notes.

Although there are exceptions, most structured notes fall into two broad categories: (i) structured notes that are "principal-protected"[17] and thus generally treated as debt instruments for U.S. federal income tax purposes ("Debt Notes") and (ii) structured notes that are not principal-protected (*i.e.*, "principal-at-risk" notes) and, thus, generally treated either as non-debt derivative contracts or as instruments consisting of multiple components for U.S. federal income tax purposes (*i.e.*, "bifurcated" or "disaggregated" notes).[18]

Since the key line of demarcation between these two categories is principal protection, that is the best place to start the discussion of characterization.

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[14] *See* David A. Weisbach, *Tax Response to Financial Contract Innovation*, 50 TAX. L. REV. 491, 496 (1995).

[15] *See* JCT Report, *supra* note 2, at 12 ("When a new or innovative product becomes available, tax professionals try to determine how it should be taxed by picking the most closely analogous product for which rules exist and then assigning the new product to the existing cubbyhole. The tax consequences for the instrument then follow from the tax characteristics of the cubbyhole to which the instrument is assigned."). *See, e.g.*, Notice 2004-52, I.R.B 2004-32 (listing potential tax characterizations of credit default swaps by reference to analogous transactions). *Cf. Bank of America v. United States*, 680 F.2d 142, 147 (Ct. Cl. 1982) ("When an item of income is not classified within the confines of the statutory scheme nor by regulation, courts have sourced the item by comparison and analogy with classes of income specified within the statutes.").

[16] *See* Weisbach, *supra* note 14, at 500. *See also* Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1355 (1991) ("Reasoning by analogy is a potent tool when applied to incremental variations on a familiar theme, but it fails miserably when applied to genuine innovations.").

[17] This paper discusses the definition of "principal protection" in Part II.b.i.3 *infra*.

[18] *Cf.* JCT Report, *supra* note 2, at 30 ("Under present law, the assurance of a repayment of one's investment has served as a sort of dividing line between circumstances in which income imputation is required and those in which it is not.").

b. Principal-Protected Notes—Debt Instruments

One simple example of a structured note is a "market protection note" ("MPN"). Assume a holder pays $1,000 for a note with a five-year term and no periodic payments of interest or coupons, which returns, at maturity, $1,000 plus the percentage increase, if any, in the S&P 500 from the issue date to the maturity date (subject to a cap of $600). If the value of the S&P 500 was $2,000 on the issue date and is $2,800 on the maturity date (*i.e.*, the S&P 500 increased by 40%), the holder will receive $1,400 at maturity. Alternatively, if the value of the S&P 500 is $3,400 on the maturity date (*i.e.*, the S&P 500 increased by 70%), all else equal, the holder will receive $1,600 at maturity.

For the reasons discussed below, practitioners generally would treat this MPN as a debt instrument for U.S. federal income tax purposes. As discussed further below, this note likely should be treated as a contingent payment debt instrument (a "CPDI").

i. Level of Principal Protection

1. Not Debt vs. Equity; Debt vs. "Something Else"

The most common question that arises regarding the characterization of financial instruments is whether a particular financial instrument should be characterized as debt or equity of the issuer for U.S. federal income tax purposes.[19] For many reasons, a typical structured note should *not* be treated as equity of the issuer. Typically, a structured note is relatively short-dated, provides for creditor's rights, and does not grant the holder a right to participate in the issuer's "corporate adventure"[20]—*i.e.*, the performance of the structured note is not linked to the performance of the issuer. For example, in FSA 200131015, the IRS analyzed a "DECS" transaction,[21] which very generally is a "private" structured note consisting of a variable-prepaid forward contract stapled to a deposit.[22] The IRS concluded that DECS should not be treated as equity of the issuer:

> The Instruments also lack certain characteristics that would indicate that the Instruments are equity interests in [the issuer]. The holders do not have the right to participate in [the issuer's] management (or [the management of the reference stock issuer], for that matter).

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[19] *See* William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971). *See, e.g.*, *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946); *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968).

[20] *See* Farber, *supra* note 6, at 664. *See, e.g.*, *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990, 993 (6th Cir. 1943) (noting that "[t]he essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit.").

[21] For much more on DECS, see *infra* Part II.c.iii.1.A.

[22] Throughout this paper, except where explicitly noted otherwise, the term "deposit" is used in its colloquial sense and not as it is defined in Code Sec. 871(i)(3) or as the term "deposit" otherwise may be specially defined for U.S. federal income tax purposes.

> The amount due to the holders is unrelated to the economic performance of [the issuer] and is not convertible into [the issuer] stock (but is instead convertible to [the reference] stock). There is apparently no reason to believe there is a substantial overlap between the holders of the Instruments and [the issuer] stockholders and [the issuer] is apparently not thinly capitalized.[23]

For Debt Notes, the debt-equity question is slightly more acute. However, as noted above, most issuers of structured notes tend to be highly-creditworthy and well-capitalized financial institutions, and the yields on Debt Notes generally tend to be approximately those of investment grade debt.[24] Moreover, these instruments have creditor's rights and an unconditional promise to pay a sum certain. Accordingly, it is fairly straightforward to conclude that Debt Notes do not constitute equity of the issuer under the traditional debt-equity factors.[25]

Accordingly, the most common approach to characterizing a structured note for U.S. federal income tax purposes is to determine whether it should be treated as debt or as a different type of financial instrument (*e.g.*, a prepaid derivative contract treated as a non-debt open transaction, etc.).

2. Authority and Guidance

To put it simply, when a structured note is sufficiently "principal-protected," structured note tax practitioners invariably treat it as a Debt Note. This is because the *sine qua non* of indebtedness is an unconditional promise to pay a sum certain.[26] If principal repayment is guaranteed under the terms of the instrument, Debt Note treatment is extremely compelling because structured notes have many of the other indicia of debt—*viz*. a defined term, creditor's rights, and seniority to the issuer's equity. It is also potentially helpful that such instruments are denominated as "notes," which may suggest that they are debt in form. Accordingly, because the

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[23] *See also* FSA 200150012.

[24] Often, Debt Notes are issued from an SEC-registered shelf with a provisional "investment grade" rating. *See* Jason Schwartz & David S. Miller, *Collateralized Loan Obligations*, 6585-1ST TAX MGMT. PORT. (BNA), at II.A.1 (2024); ("It is typical for a CLO's deal counsel to opine that the secured notes that receive investment grade credit ratings 'will' be debt for U.S. tax purposes.").

[25] *See, e.g.*, Notice 94-47; 1994-1 C.B. 357.

[26] *See, e.g.*, *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957); *Johnson v. Commissioner*, 108 F.2d 104 (8th Cir. 1939) ("The term 'indebtedness' as used in the Revenue Act implies an unconditional obligation to pay."); *Wood Preserving Corp. v. United States*, 347 F.2d 117, 119 (4th Cir. 1965) (listing "an obligation to repay in all events" as one of two "indispensable indicia of a creditor relationship"); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968) (considering "a contingency on the obligation to repay" in whether a financial instrument was debt for U.S. federal income tax purposes); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987) (debt treatment "depends on whether the objective facts establish an intention to create an unconditional obligation to repay the advances"); *Towne Square, Inc. v. Commissioner*, 45 T.C.M. 478 (1983) ("A bona fide debt . . . is classically 'an unqualified obligation to pay a sum certain . . . .'"); *Commissioner v. Page Oil Co.*, 129 F.2d 748 (2d Cir. 1942) (noting that "[t]he fact that ultimately [one] must be paid a definite sum at a fixed time marks his relationship to the corporation as that of creditor rather than shareholder").

holder is guaranteed to be repaid at least its entire investment, the MPN described above should be treated as a debt instrument for U.S. federal income tax purposes.

What is the requisite level of principal protection? For example, would a note that guarantees a minimum return of 60% of the holder's purchase price be treated as a debt instrument for U.S. federal income tax purposes?

A few data points inform this inquiry. First, Treas. Reg. § 1.1275-5(a)(2) and (5) provide that an instrument cannot qualify as a variable rate debt instrument ("VRDI") if the issue price of the instrument exceeds its noncontingent principal payments by more than the lesser of (i) 1.5% of the total such payments times complete years to maturity and (ii) 15% of such payments. This means that a ten-year instrument with 85% principal protection can qualify as a VRDI (and thus *must* be a debt instrument for U.S. federal income tax purposes).

Second, in Rev. Rul. 83-98,[27] the IRS addressed adjustable-rate convertible notes with 60% principal protection and ruled that the notes were not properly classified as debt for U.S. federal income tax purposes. The notes were issued at $1,000 a share, which was equivalent to 50 shares of the taxpayer's common stock (which was trading at $20 per share). At maturity, the holders had the right to elect to receive either $600 or 50 shares of common stock. This relatively low level of principal protection (combined with other equity-like features of the instrument) led the IRS to conclude that the notes were equity, not debt, for U.S. federal income tax purposes, because—under the most likely scenario—a holder of a note would exercise its right to convert the instrument into common stock. However, it is difficult to draw a clear inference from Rev. Rul. 83-98 that a structured note with only 60% principal protection is not properly characterized as debt. The ruling analyzed whether the notes were debt or equity. As discussed above, it is very unlikely that most structured notes could be properly characterized as equity for U.S. federal income tax purposes. Moreover, the debt vs. equity inquiry is different from the debt vs. derivative inquiry, so much of the analysis in the ruling is not relevant to structured notes. For example, the ruling examined the level of principal protection solely insofar as the low level of principal protection increased the probability that the notes would be converted into stock. The ruling also took into account additional factors not relevant to most structured notes, such as the fact that the value of the stock into which the notes would convert exceeded the level of principal protection at issuance, and the fact that the yield on the notes was linked to dividends.

Third, PLR 200628001,[28] sometimes referred to as the "Rydex ruling," could be read to say that the IRS concluded 55% principal protection is insufficient to cause an instrument to be treated as debt for U.S. federal income tax purposes. This ruling addressed a regulated investment company (a "RIC") that invested in commodity-linked notes with a term of one year and one day. The payout of the notes was determined by reference to the performance of a commodity index. It is generally understood that the notes provided that the RIC would gain or lose $3 for every $1 that the index increased or decreased. The notes would be redeemed if the index fell by 15% or more. In light of the 3x leverage, the notes would be automatically redeemed if the RIC lost 45% of its investment—*i.e.*, the notes could be viewed as having 55% principal protection. On these

[27] 1983-2 C.B. 40.

[28] 2006-2 I.R.B. 261.

facts, the IRS ruled that the notes gave rise to "qualifying income" for RIC purposes.[29] Since a debt instrument would *automatically* generate "qualifying income" in the form of interest,[30] and the IRS did not address that fact, one can assume that the IRS did not view the notes as debt for U.S. federal income tax purposes.[31] Garlock cites the Rydex ruling for the following proposition: "[M]ost practitioners do not believe certain commodities-linked notes regulated investment companies purchase are debt, given that the 'principal' returned could be as low as 55-70 percent of the original investment."[32]

There are other clues. For example, in prior proposed regulations under Code Sec. 385 (issued in 1980 and withdrawn in 1983), the IRS and Treasury generally concluded that an instrument would be treated as debt if, on the date of issue, the present value of noncontingent principal and interest payments was 50% or more of the fair market value of the instrument.[33] Treas. Reg. § 1.1274-5(b)(4)(vi), Example 1 discusses the application of the CPDI rules to an instrument issued for $1,000,000 that provided for a minimum repayment of $650,000 plus $60,000 of interest for ten years (*i.e.*, 65% principal protection taking into account only principal repayment, and 125% principal protection taking into account principal and fixed interest).[34] On the other hand, in ILM 199943037, the IRS apparently had no trouble concluding that an instrument with 75% principal protection was debt for U.S. federal income tax purposes. The instrument provided that, if a certain condition was met (which was probable), the issuer could satisfy the instrument in full by paying 75% of the stated principal at maturity (without any interest).[35]

A. Multicurrency Instruments

Before moving on to what conclusions structured note tax practitioners divine from the hodgepodge of authority and guidance discussed above, it is worth a brief note on structured notes that involve more than one currency. Such "multicurrency" notes can be tremendously complex and are outside of the scope of this paper.[36] One principle, however, is clear: Under Rev. Rul. 2008-

[29] *See generally* Code Sec. 851(b)(2).

[30] *See* Code Sec. 851(b)(2)(A).

[31] For further discussion of the Rydex ruling, see Farber, *supra* note 6, at 655–656.

[32] *See, e.g.*, DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS ¶ 102.03[A] (2025).

[33] *See generally* Prop. Reg. 1.385-5 (withdrawn). Note that these regulations were withdrawn because they did not "fully represent the position of the Treasury Department or the Internal Revenue Service on matters concerning debt and equity." T.D. 7920, 1983-2 CB 69.

[34] Note that the CPDI regulations explicitly provide that "no inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes." *See* Treas. Reg. § 1.1275-4(b)(iv).

[35] The author is grateful to Jiyeon Lee-Lim and Bora Bozkurt for highlighting this IRS memorandum. *See* Jiyeon Lee-Lim & Y. Bora Bozkurt, *Significant Modification of Debt Instruments: A Case Study*, 154 TAX NOTES 1647 (2017). Aside from that excellent article, the author is not aware of any commentary discussing this ILM, particularly in the context of the requisite amount of principal protection to treat an instrument as debt for U.S. federal income tax purposes.

[36] For an excellent but challenging discussion of these issues, see Dimon, *supra* note 6.

1,[37] an instrument linked to two currencies will be treated as principal-protected if it is principal-protected in *either* currency.[38] The ruling concluded that an instrument issued and repaid in USD that provided for a return determined by a fixed amount of EUR (plus interest linked to the EUR) was an EUR-denominated debt instrument for U.S. federal income tax purposes. The IRS acknowledged that there was a significant possibility that the USD equivalent amount payable by issuer at maturity would be less than the USD amount of the holder's investment. Moreover, the IRS conceded that the instrument resembled a prepaid forward contract: "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 [*i.e.*, an amount of EUR] at maturity." Nevertheless, the ruling concluded that the instrument was debt for U.S. federal income tax purposes because it was principal-protected in EUR. It is generally understood that the issuer had attempted to treat the instrument as a forward contract for purposes of the Code Sec. 988 rules, which would have made it potentially eligible for the Code Sec. 988(a)(1)(B) capital asset election; Rev. Rul. 2008-1 thwarted that attempt.

3. Market Practice

Structured note tax practitioners generally measure principal protection by comparing the total amount of noncontingent payments (*i.e.*, principal and fixed interest payments) to the issue price of the note. However, it is not entirely clear whether this analysis should take into account only noncontingent payments of principal or *all* noncontingent payments (including fixed interest). In many cases, determining that a note is sufficiently principal protected to qualify as a Debt Note would cause that note to be treated as a CPDI for U.S. federal income tax purpose, which is generally adverse to U.S. Holders, who often have to accrue phantom income under the CPDI rules and can never recognize long-term capital gain (since all gains with respect to a CPDI are treated as ordinary). If CPDI treatment is generally more adverse to holders than the alternative (*e.g.*, a prepaid derivative treated as an "open transaction" that allows for the possibility of long-term capital gain), the conservative approach would be to test for principal protection taking into account *all* noncontingent payments, since this is more likely to cause the note to be treated as a Debt Note and, thus, a CPDI.

Taking into account all of the above authorities, practitioners generally conclude that a structured note is treated as debt for U.S. federal income tax purposes at some level of comfort if it provides for principal protection of 85% or more. Some advisors reach a higher level of comfort (*e.g.*, "should") on debt-for-tax treatment if the note is 90% or more principal-protected,[39] and a lower level of comfort (*e.g.*, "more likely than not" or "reasonable to treat") if the note is 85% or more but less than 90% principal-protected. The implications of a lower level of principal protection than 85% are discussed in Part II.c.i.2 *infra*. As discussed in that section, even if a particular note is not sufficiently principal protected pursuant to its terms to qualify as a Debt Note

[37] 2008-1 C.B. 248.

[38] Note that virtual currency is not foreign currency for U.S. federal income tax purposes, so this approach is not appropriate to notes linked to virtual currencies such as Bitcoin. *See* Notice 2014-21, 2014-16 I.R.B. 938.

[39] *See, e.g.*, GARLOCK, *supra* note 32, at ¶ 102.03[A] ("Practitioners are generally comfortable that an instrument that promises a sum certain of at least 90 percent of the issue price will not fail to qualify as debt on this ground, but the level of confidence drops off rapidly as the percentage decreases.").

(*e.g.*, it has *zero* principal protection under the terms of the instrument), but the *actual risk* of the holder losing a substantial portion of its investment is very low, some structured note tax practitioners are comfortable treating the note as a Debt Note.

ii. Various Types of Debt Notes

A Debt Note generally can be further sub-categorized into four cubbyholes: (i) "plain vanilla" debt, which may or may not bear original issue discount ("OID"), (ii) a VRDI, (iii) a CPDI, or (iv) a short-term obligation. In addition to the aforementioned categories, Debt Notes may also be subject to special rules under the OID regulations, including the "significantly more likely than not" payment schedule rule, discussed below in Part III.a.ii. Since there are many excellent treatises and commentaries that discuss the rules governing the taxation of debt instruments in detail,[40] this section of the paper focuses on a selection of the specific issues these rules present in the structured note context.

1. Plain Vanilla Debt

Structured notes are treated as "plain vanilla" (*i.e.*, non-VRDI, non-CPDI, non–short-term) debt if they have a term of more than one year and do not provide for any contingent payments. Qualified stated interest ("QSI")—*i.e.*, interest that is unconditionally payable at least annually at a single fixed rate[41]—is generally taxable to U.S. Holders as ordinary income at the time it is received or accrued (depending on the particular U.S. Holder's method of accounting for tax purposes). Notwithstanding their method of accounting, if OID is present, U.S. Holders will account for such OID under the OID regulations.[42] Upon a sale, exchange, or retirement of a plain vanilla Debt Note, U.S. Holders generally recognize capital gain or loss equal to the difference between the amount realized on the sale, exchange, or retirement (other than amounts attributable to accrued interest)[43] and the U.S. Holder's tax basis in the note.[44] This gain or loss generally will be long-term capital gain or loss if, at the time of the sale, exchange, or retirement, the U.S. Holder held the note for more than one year and short-term capital gain or loss otherwise. Non-U.S. Holders generally receive QSI and OID free of U.S. withholding taxes because they generally qualify for the portfolio interest exemption with respect to interest paid on such structured notes.[45] The portfolio interest exemption is discussed in more detail in Part II.b.ii.2.C.i *infra*.

For all Debt Notes discussed in this article, including plain vanilla Debt Notes, Non-U.S. Holders generally are not subject to U.S. withholding tax with respect to proceeds from the sale, exchange, or retirement of a Debt Note both because such proceeds do not represent FDAP and

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[40] *See, e.g.*, GARLOCK, *supra* note 32; Marion & Moin, *supra* note 6.

[41] *See* Treas. Reg. § 1.1273-1(c)(1).

[42] *See* Treas. Reg. §§ 1.1271-1 through 1.1275-7.

[43] *See* Treas. Reg. § 1.61-7(d).

[44] *See* Code Sec. 1271(a)(1) ("Amounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefor.").

[45] *See* Code Sec. 871(h); Code Sec. 881(c).

because such proceeds should be non-U.S. source income.[46] The Foreign Investment in Real Property Tax Act rules ("FIRPTA"), FATCA, and Section 871(m) are all potential exceptions to this general rule. FIRPTA is discussed in Part III.g *infra*.

2. VRDIs & CPDIs

A. Overview

A Debt Note with a term of more than one year providing for contingent payments generally will be treated either as a VRDI or CPDI (subject to certain exceptions).[47] The VRDI rules trump the CPDI rules—*i.e.*, if a structured note qualifies as a VRDI, it will not be treated as a CPDI.[48] By contrast, if a Debt Note that provides for a variable rate of interest does not qualify as a VRDI, the debt instrument is a CPDI.[49] The VRDI and CPDI rules have been discussed extensively elsewhere.[50] Parts II.b.ii.2.B and II.b.ii.2.C provide some (very brief) background on the VRDI and CPDI rules, respectively, for those unfamiliar with the rules or those looking for a refresher. Those sections of the paper do not cover all of the relevant rules but merely provide the highlights. Part III.a focuses on some interesting VRDI and CPDI issues that arise in the structured note context.

B. A Brief Summary of the VRDI Rules

An instrument with contingent payments generally qualifies as a VRDI if it provides for stated interest that is compounded or paid at least annually at one of four possible rates: (i) one or more qualified floating rates, (ii) a single fixed rate and one or more qualified floating rates, (iii) a single objective rate, or (iv) a single fixed rate and a single objective rate that is a qualified inverse floating rate.[51] A qualified floating rate generally is a rate in which variations can reasonably be expected to measure variations in the costs of newly borrowed funds in the currency in which the debt instrument is denominated (*e.g.*, SOFR).[52] A qualified inverse floating rate generally is one that moves inversely to the cost of newly borrowed funds in the currency in which the debt instrument is denominated (*e.g.*, a rate that increases when the corresponding benchmark rate

[46] *See* Code Sec. 865(a).

[47] *See generally* Treas. Reg. §§ 1.1275-4 (CPDI rules); 1.1275-5 (VRDI rules).

[48] *See* Treas. Reg. § 1.1275-4(a)(2)(ii).

[49] *See* Treas. Reg. § 1.1275-5(a)(1).

[50] *See, e.g., supra* note 40.

[51] *See* Treas. Reg. § 1.1275-5(a)(3)(i). A special rule applies to debt instruments that bear interest at a fixed rate for an initial period that permits the fixed rate and the variable rate together to constitute a single qualified floating rate or objective rate. *See* Treas. Reg. § 1.1275-5(a)(3)(ii).

[52] *See* Treas. Reg. § 1.1275-5(b)(1). Special rules apply for purposes of determining whether a rate is treated as a qualified floating rate. *See generally* Treas. Reg. § 1.1275-5(b).

decreases);[53] seeing a note linked to a qualified inverse floating rate is the "equivalent of sighting an ivory-billed woodpecker."[54] An objective rate of interest generally is a rate that is (i) determined using a single fixed formula, (ii) based on objective financial or economic information, and (iii) not a qualified floating rate.[55]

In addition to the requirements above, a debt instrument must satisfy three additional tests to be treated as a VRDI: (i) as noted above, the issue price cannot exceed the noncontingent principal payments by more than the lesser of (x) 1.5% for each complete year to maturity or (y) 15%; (ii) the initial rate of interest must be equal to the current value of the relevant rate; and (iii) all principal payments must be noncontingent.[56]

Let us return to the example of the MPN discussed in Part II.b *supra*, which involves a holder paying $1,000 for a note with a five-year term and no periodic payments or coupons that returns, at maturity, $1,000 plus the percentage increase, if any, in the S&P 500 from the issue date to the instrument's maturity (subject to a cap of $600). Although the formula pursuant to which the principal repayment is computed *might* qualify as an objective rate (as discussed further in Part III.b.i) *infra*, the MPN does not qualify as a VRDI, because there is no stated interest that is compounded or paid at least annually; all amounts are paid at maturity.

i. Treatment of Holders

If a Debt Note is treated as a VRDI and does not bear OID, a U.S. Holder includes interest as ordinary income at the time it is received or accrued, depending on the U.S. Holder's method of accounting for tax purposes. Upon a sale, exchange, or retirement of the note, the U.S. Holder generally will recognize capital gain or loss equal to the difference between the amount realized on the sale, exchange, or retirement (other than amounts attributable to accrued interest) and the U.S. Holder's tax basis in the note. This gain or loss generally will be long-term capital gain or loss if, at the time of the sale, exchange, or retirement, the U.S. Holder held the note for more than one year and short-term capital gain or loss otherwise. As with plain vanilla debt, Non-U.S. Holders generally receive QSI and OID on a VRDI free of U.S. withholding taxes because they generally qualify for the portfolio interest exemption.

ii. A Brief Note on VRDIs with OID

A special set of rules governs the application of the OID regulations to VRDIs. Very generally, the regulations "convert the debt instrument into a fixed rate debt instrument and then apply the general OID rules to the debt instrument."[57] The regulations set forth three sets of rules,

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[53] *See* Treas. Reg. § 1.1275-5(c)(3). Special rules apply for purposes of determining whether a rate qualifies as an objective rate. *See generally* Treas. Reg. § 1.1275-5(c).

[54] Edward D. Kleinbard, *Taxing Convertible Debt: A Layman's Perspective*, 56 S.M.U. L. REV. 453, 456 (2003).

[55] *See* Treas. Reg. § 1.1275-5(c)(1).

[56] *See* Treas. Reg. §§ 1.1275-5(a)(2) through 1.1275-5(a)(5).

[57] Treas. Reg. § 1.1275-5(e)(1).

respectively, for (i) VRDIs that provide for a single variable rate,[58] (ii) VRDIs not in the preceding category that do not provide for a fixed rate (*e.g.*, VRDIs with multiple floating rates—such as six-month SOFR for the first three years and the six-month T-bill rate for the final three years),[59] and (iii) VRDIs that provide for a single fixed rate.[60] The first step in each case is generally to determine the "equivalent fixed rate debt instrument." The equivalent fixed rate debt instrument has terms that are identical to the VRDI except it provides for the fixed rate substitutes in lieu of the qualified floating rates or objective rate.[61] The fixed rate substitute for an objective rate is a fixed rate that reflects the yield that is reasonably expected for the debt instrument.[62] The fixed rate substitute for a variable rate that is not an objective rate generally is the value of the variable rate on the issue date for the note.[63] Once the taxpayer constructs the equivalent fixed rate debt instrument, QSI and OID are generally determined "under the rules applicable to fixed rate debt instruments."[64] The rules for VRDIs that provide for a single fixed rate are extremely complex.[65]

C. A Brief Summary of the CPDI Rules

If the VRDI regulations and other exceptions to the CPDI rules do not apply, a Debt Note providing for contingent payments will generally be treated as a CPDI. Under the CPDI regulations, an instrument that is issued for cash is subject to the OID regulations under the "non-contingent bond method."[66] Under that method, the issuer constructs a "projected payment schedule" for the instrument, which generally remains fixed throughout the term of the debt instrument, and determines the "comparable yield"—*i.e.*, the yield at which the issuer would issue a non-contingent fixed rate debt instrument with terms and conditions similar to the actual instrument.[67] However, a special rule provides that the comparable yield may not be less than the applicable federal rate published by the Treasury.[68] The projected payment schedule must produce

[58] *See* Treas. Reg. § 1.1275-5(e)(2).

[59] *See* Treas. Reg. § 1.1275-5(e)(3).

[60] *See* Treas. Reg. § 1.1275-5(e)(4).

[61] Treas. Reg. § 1.1275-5(e)(3)(ii).

[62] *See* Treas. Reg. § 1.1275-5(e)(2)(ii)(B); Treas. Reg. § 1.1275-5(e)(3)(i)(C).

[63] *See* Treas. Reg. § 1.1275-5(e)(2)(ii)(A); Treas. Reg. § 1.1275-5(e)(3)(i)(A)–(B).

[64] *See* Treas. Reg. § 1.1275-5(e)(2)(ii); Treas. Reg. § 1.1275-5(e)(3)(iii).

[65] For an excellent overview of those rules, see Marian, *supra* note 6, at 326–27.

[66] *See generally* Treas. Reg. § 1.1275-4(b).

[67] *See* Treas. Reg. § 1.1275-4(b)(3)(i)–(ii); Treas. Reg. § 1.1275-4(b)(4)(i)(A).

[68] *See* Treas. Reg. § 1.1275-4(b)(4)(i)(A).

the comparable yield.[69] If the projected payment schedule does not produce the comparable yield, the schedule must be adjusted to produce the comparable yield.[70]

i. Treatment of Holders

The amount a U.S. Holder accrues as OID in each accrual period is the product of the comparable yield (properly adjusted for the length of the accrual period) and the CPDI's adjusted issue price at the beginning of the accrual period.[71] When a payment is actually made, a U.S. Holder must account for any differences between projected and actual contingent payments by making "positive" or "negative" adjustments.[72] Any positive adjustment for a taxable year is treated as additional OID income of the U.S. Holder.[73] Any net negative adjustment reduces any OID on the note for the taxable year that would otherwise accrue.[74] Any excess is then treated as a current-year ordinary loss to the U.S. Holder to the extent of OID accrued in prior years; any excess is carried forward and any remaining carryforwards reduce amount realized on the sale, exchange, or retirement of the instrument.[75] Importantly, net negative adjustments are not treated as "miscellaneous itemized deductions," and, thus, individual U.S. Holders may be eligible for a deduction.[76] Gain on the sale, exchange, or retirement of a CPDI generally is treated as interest (*i.e.*, ordinary income).[77] Loss, on the other hand, is treated as ordinary loss only to the extent of the U.S. Holder's prior net inclusions (*i.e.*, reduced by the total net negative adjustments previously allowed to the U.S. Holder as an ordinary loss) and as capital loss beyond that extent.[78] The mechanics of the CPDI rules ensure that a holder of a CPDI will recognize a capital loss only if the instrument provides for a contingent principal payment and the total payments received are less than the holder's initial investment.[79]

Note that CPDI treatment is generally disadvantageous for U.S. Holders. There is no possibility of capital gain, and CPDIs often generate "phantom income" because accrued OID often exceeds payments made on the note.

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[69] *See* Treas. Reg. § 1.1275-4(b)(4)(i)(C).

[70] *Id.*

[71] *See* Treas. Reg. § 1.1275-4(b)(3)(iii).

[72] *See* Treas. Reg. § 1.1275-4(b)(4)(iv).

[73] *See* Treas. Reg. § 1.1275-4(b)(6)(ii).

[74] *See* Treas. Reg. § 1.1275-4(b)(6)(iii).

[75] *Id.*

[76] *See* Treas. Reg. § 1.1275-4(b)(6)(iii)(D).

[77] *See* Treas. Reg. § 1.1275-4(b)(8)(i).

[78] *See* Treas. Reg. § 1.1275-4(b)(8)(ii).

[79] *See* GARLOCK, *supra note* 32, at ¶ 904.03[C] n.78.

As with other Debt Notes, Non-U.S. Holders generally receive QSI and OID on a CPDI free of U.S. withholding taxes because they generally qualify for the portfolio interest exemption. It is worth pausing on why this is the case. Let us return to the example of the MPN discussed in Part II.b *supra*, and make a small modification. Assume that a holder pays $1,000 for a note with a five-year term, no periodic payments or coupons, which returns at maturity $1,000 plus the percentage increase, if any, in *an ETF linked to the S&P 500* from the issue date to the instrument's maturity (subject to a cap of $600). Almost invariably, the issuer will hedge its downside exposure on the note (*i.e.*, the risk that it will pay higher principal on the note if the ETF share price increases) by acquiring long exposure to the ETF. Assume that, in this case, the issuer purchases shares of the ETF as a hedge. At first glance, one might be inclined to conclude that the interest on the MPN possibly does not qualify for the portfolio interest exemption because it is subject to a prohibited contingency—the interest is determined by reference to a "change in value of . . . property of the debtor" (*i.e.*, the ETF shares that the issuer holds as a hedge).[80] However, the Code creates an exception to this rule for interest determined by reference to changes in the value of "actively-traded property," as defined in Code Sec. 1092(d), other than U.S. real property interests.[81] Since the S&P 500 ETF should be actively-traded property within the meaning of Code Sec. 1092(d), the interest payable on the CPDI should qualify as portfolio interest. Basic economics dictates why this is the case for almost all structured notes that provide for contingent interest: the issuer must hedge its exposure on the note easily and inexpensively; accordingly, the underlying Reference Asset to which the Debt Note is linked generally must be quite liquid—it will generally be the kind of property that qualifies as actively-traded.

3. Short-Term Obligations ("STOs")[82]

Notwithstanding the rules for plain vanilla debt, VRDIs, and CPDIs, a Debt Note that has a fixed maturity date not more than one year from the issue date is subject to the arcane rules that govern STOs. In determining whether a debt instrument is an STO, the holding period of the debt instrument is measured including either the issue date or the maturity date but not both dates.[83] Moreover, in determining whether a debt instrument is an STO, the maturity date is the last possible date that the instrument could be outstanding under the terms of the instrument.[84] Accordingly, even if an option is deemed exercised that would cause the tenor of the instrument to be shorter than one year,[85] that option is ignored for purposes of determining whether the debt instrument is an STO. For purposes of applying this rule, the last possible date that the debt instrument could be outstanding is determined by *taking into account* "remote" or "incidental"

[80] *See* Code Sec. 871(h)(4)(A)(i)(III).

[81] *See* Code Sec. 871(h)(4)(C)(v)(I).

[82] Aside from the Garlock and Keyes treatises, which are cited in this section of the paper, for a superb overview of these rules, see Jeff Maddrey, *Time Value of Money — Holders of Debt Instruments*, 181-1st TAX MGMT. PORT. (BNA), at IV.C (2024).

[83] *See* Treas. Reg. § 1.1272-1(f)(1).

[84] *See* Treas. Reg. § 1.1272-1(f)(2).

[85] *See* Treas. Reg. § 1.1272-1(c)(5).

contingencies, which, generally, are otherwise ignored for purposes of the OID regulations.[86] As a result, even a very unlikely contingency, or one that is very small in magnitude of economic impact, can render a Debt Note a non-STO.

Several of the normal rules that apply to debt instruments do not apply to STOs. First, the current accrual rules that generally apply to OID do not apply to STOs.[87] The OID regulations provide that, in the case of an STO, no payments of stated interest are treated as QSI.[88] This is a critical rule and will be a recurring theme in this discussion of STOs. To be clear, an STO generally will bear OID as a result of Treas. Reg. § 1.1273-1(c)(5), but the rules that require *current accrual* of such OID under Code Sec. 1272(a)(2)(C) and Treas. Reg. § 1.1272-1 are "turned off" for STOs.[89] Second, the market discount rules apply to STOs.[90] Third, although neither the Code nor the regulations make this explicit, the bond premium rules also do not apply to short-term obligations, because bond premium is a function of QSI and STOs have no QSI.[91]

There are essentially two regimes that govern U.S. Holders of STOs.[92] As discussed below, which regime a U.S. Holder follows is determined by whether they are subject to Code Sec. 1281 or not.

A. U.S. Holders Subject to Code Sec. 1281

Under Code Sec. 1281, certain categories of U.S. Holders (including holders that use the accrual method, regulated investment companies, and banks),[93] must accrue the OID—*i.e.*, the excess of stated redemption price at maturity ("SRPM") over the adjusted issue price on date of purchase—on an STO on a current basis.[94] Unlike the "normal" OID regulations, the Code Sec.

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[86] *See id.*

[87] *See* Code Sec. 1272(a)(2)(C) (excepting STOs from OID current inclusion regime).

[88] Treas. Reg. § 1.1273-1(c)(5).

[89] *See id.*

[90] *See* Code Sec. 1278(a)(1)(B)(i) (excepting STOs from the market discount rules).

[91] *See* Maddrey *supra* note 82.

[92] Since this paper focuses on structured notes, this section omits any discussion of governmental STOs, which are subject to special rules. *See, e.g.*, Code Sec. 1271(a)(3). For an overview of the rules for governmental STOs, see generally Maddrey *supra* note 82.

[93] *See* Code Sec. 1281(b)(1)(A), (C) & (D).

[94] The Code is awkwardly drafted, and initially one might be inclined to think that the rules apply to "acquisition discount," (*i.e.*, the difference between the SRPM and the holder's initial tax basis) which captures amounts that would otherwise be OID *or* market discount. However, this is the rule only for governmental STOs. In the case of a nongovernmental STO, it is clear that U.S. Holders subject to Code Sec. 1281 must accrue only OID. *See* Code Sec. 1283(c)(1). Note that, among the many other elections available under the STO regime, Code Sec. 1283(c)(2) permits a U.S. Holder subject to Code Sec. 1281 to elect to accrue "acquisition discount" instead of OID on a nongovernmental STO. This election would potentially benefit a U.S. Holder that purchased an STO after its original issue at a price greater than the STO's adjusted issue price at the time of acquisition. This election applies to all nongovernmental STOs held by the U.S. Holder and can only be revoked through the consent of the IRS Commissioner.

1281 rules require a U.S. Holder to accrue the "sum of the daily portions" of OID for each day of the year in which the STO is held—as a result, the OID accrues in equal daily installments (*i.e.*, on a "straight line" basis), not on a constant yield basis.[95] The adjusted basis of an STO is increased by the amount of OID included in the U.S. Holder's gross income under Section 1281.[96] One interesting implication of the Code Sec. 1281 regime is that if a U.S. Holder subject to Code Sec. 1281 acquires an STO for an amount below the adjusted issue price on the date of purchase (*i.e.*, with what would otherwise be market discount), and this amount results in gain upon the retirement of the STO, the gain will be capital.

The tax treatment of stated interest on an STO subject to Code Sec. 1281 is not entirely clear. Code Sec. 1281(a)(2) provides that stated interest on an STO is includable in the U.S. Holder's income as it accrues. This may be read to imply that the stated interest is included by an accrual method U.S. Holder when the *stated* amount accrues. However, because no amounts payable on an STO are QSI, it is also possible that the stated interest instead is converted into OID and is taken into account when that *OID* amount accrues under Code Sec. 1281(a)(1). This second approach is sensible because, otherwise, it might be possible to avoid the Code Sec. 1281 rules and achieve deferral by transforming what would otherwise be OID into stated interest that is paid and accrued in a later year (in the case of an STO that straddles two tax years).[97]

B. U.S. Holders Not Subject to Code Sec. 1281

U.S. Holders not subject to Code Sec. 1281 (*e.g.*, individuals on the cash method) are not required to accrue any amounts on an STO. However, under Code Sec. 1271(a)(4), such U.S. Holders are required to treat gain from a sale, exchange, or retirement of the STO as ordinary to the extent of OID that would have accrued had Code Sec. 1281(a) applied. Moreover, there is an additional price for deferral: under Code Sec. 1282, U.S. Holders not subject to Code Sec. 1281 are required to defer "net direct interest expense" ("NDIE") attributable to their investment STOs. NDIE is the amount of interest paid or accrued during the taxable year on indebtedness that is incurred or extended to purchase or carry the STO.[98] NDIE is allowed as a deduction only to the extent that it exceeds the sum of (i) the daily portions of OID for the year and (ii) any interest payable on the STO (other than OID) that accrues on the obligation but is not included in the U.S. Holder's income by reason of his or her method of accounting.[99] A U.S. Holder not otherwise subject to Code Sec. 1281 may elect to apply Code Sec. 1281, and thus "turn off" the application of Code Sec. 1282.[100] This election applies to all STOs acquired by the U.S. Holder and is revocable

[95] *See* Code Sec. 1283(b)(1). In lieu of this regime, a U.S. Holder subject to Code Sec. 1281 may elect to accrue OID using yield to maturity concepts. *See* Code Sec. 1283(b)(2). This constant yield election is made on an STO-by-STO basis and is irrevocable. *See id.* There is no method prescribed for making this election.

[96] *See* Code Sec. 1281(d)(2).

[97] *See* KEVIN M. KEYES, FEDERAL TAXATION OF FINANCIAL INSTRUMENTS & TRANSACTIONS ¶ 9.03[3].

[98] *See* Code Secs. 1282(c) & 1277(c).

[99] *See* Code Sec. 1282(a)(2).

[100] *See* Code Sec. 1282(b)(2).

only with the consent of the IRS Commissioner.[101] This election is generally sensible for U.S. Holders not subject to Code Sec. 1281 that engage in leveraged investments in STOs.

The treatment of stated interest on an STO in the hands of a U.S. Holder not subject to Code Sec. 1281 is not entirely clear. On the one hand, it is possible that stated interest is includable in gross income under the U.S. Holder's usual method of accounting (*i.e.*, when paid to a cash method holder). Garlock endorses this view.[102] However, because no amounts payable on an STO are QSI, others take the position that stated interest is added to the SRPM, thus, giving rise to OID which is deferred until disposition or retirement of the STO (and treated as ordinary under Code Sec. 1271(a)(4)).[103] Kevin M. Keyes was a proponent of this contrary view.[104] Accordingly, tax disclosure for structured notes sometimes provides that a U.S. Holder of an STO that is not subject to Code Sec. 1281 "*may* be required to include any stated interest in income as the interest is received."

C. Non-U.S. Holders

As with other types of Debt Notes, Non-U.S. Holders generally receive amounts payable with respect to an STO free of U.S. withholding taxes because they generally qualify for the portfolio interest exemption.

Moreover, if the term of an STO is 183 days or less, an additional exception to U.S. withholding taxes may be available. Code Sec. 871(a)(1)(C) imposes a 30% tax on U.S.-source OID accruing on an "original issue discount obligation" upon either a payment on the debt instrument or a sale or exchange of the debt instrument. This substantive tax is collected through a corresponding withholding tax. The term "original issue discount obligation" is a misnomer, because it does not apply to all obligations with OID. Rather, "original discount obligation" is a term of art in Section 871 to describe *certain* types of obligations to subject to tax in the hands of foreign persons. Code Sec. 871(g)(1)(B)(i) provides that an "original issue discount obligation" does not include any obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer).[105] Accordingly, if an STO has a term of 183 days or less, payments with respect to the STO generally should not be subject to 30% tax in the hands of foreign holders. With respect to *withholding tax*, Treas. Reg. § 1.1441-1(b)(4)(iv) clearly states that interest or OID on short-term obligations described in Code Sec. 871(g)(1)(B) is exempt from

[101] *Id.*

[102] *See* GARLOCK, *supra* note 32, at ¶ 702.02[B] ("[C]ash-method holders not subject to Code Sec. 1281 should be able to ignore Treas. Reg. § 1.1273-1(c)(5) and should simply include stated interest on short-term obligations when actually or constructively received (assuming interest is payable at a single fixed rate).")

[103] *See also* Code Sec. 1271(d), which provides that income is not included twice.

[104] *See* Keyes, *supra* note 97, at ¶ 9.04[2] ("Such interest must be added to the stated redemption price at maturity, thus creating acquisition discount or OID, which is deferred until disposition or retirement of the obligation.").

[105] *See* Code Sec. 871(g)(1)(B)(i). Code Sec. 881, which governs foreign holders that are corporations for U.S. federal income tax purposes, includes a cross-reference to Code Sec. 871(g). *See* Code Sec. 881(f).

withholding.[106] Thus, foreign holders of STOs with a term of 183 days or less should not have a substantive tax liability and should not be subject to U.S. withholding taxes, whether or not the portfolio interest exemption applies.[107]

D. Contingent STOs

The tax treatment of STOs that provide for contingent payments is a mystery. For example, assume a holder purchases, for $1,000, a seven-month note with no stated interest that pays a digital return at maturity. A digital return is a payout profile that ensures the holder will receive one of two pre-determined payoffs, depending on the performance of the Reference Asset. The note will pay $1,070 at maturity if the S&P 500 index increases from the issue date to the maturity date; otherwise, the holder will receive the par amount of $1,000 at maturity.

The author is not aware of any commentary on the subject. In the case of an STO not subject to Code Sec. 1281, the only rational approach would be to include all contingent payments at maturity. Tax disclosure generally provides some comfort that U.S. Holders not subject to Code Sec. 1281 are not required to include amounts on a contingent STO until maturity, but discloses that this result is not free from doubt and directs such U.S. Holders to consult with their tax advisors. However, the character of these payments is not entirely clear. Since no amounts payable on an STO are QSI, it seems appropriate to treat any amount received by the U.S. Holder in excess of the SRPM as ordinary income under Code Sec. 1271(a)(4).

The tax treatment of an STO governed by Code Sec. 1281 is even more confusing. Under one approach, the U.S. Holder could apply a "wait-and-see" method, and treat amounts received in excess of the issue price in income only at maturity, even in the case of an STO that straddles two tax years. Alternatively, it is possible that a U.S. Holder could apply rules analogous to the CPDI rules, accruing OID at the comparable yield and making "pseudo" positive and negative adjustments. Finally, accrual method holders of STOs (who are mandatorily subject to Code Sec. 1281) may be required to take amounts into income as such payments become "fixed."[108] Other approaches may be possible. Tax disclosure for STOs subject to Code Sec. 1281 often discusses that the treatment of such STOs is uncertain and directs U.S. Holders to consult with their (unfortunate) tax advisors.

c. Non-Principal Protected Notes—Prepaid Derivatives & Disaggregated Instruments

This Part II.c discusses the characterization of structured notes that are not sufficiently principal protected to be treated as Debt Notes. As discussed in Part II.b.i.3, structured note tax practitioners generally conclude that a structured note is treated as debt for U.S. federal income

[106] *See also* Treas. Reg. § 1.1441-2(a)(3).

[107] For a fascinating discussion of the OID rules as they apply to foreign holders, see Michael Yaghmour, *OID and the Foreign Holder: Is It Really This Hard?*, 155 TAX NOTES 1707 (Jul. 5, 2017). (Yes, Michael, it really is that hard.)

[108] *See* Treas. Reg. § 1.451-1(a).

tax purposes at some level of comfort if it provides for principal protection of at least 85%. Below this level of principal protection, issuers and their advisors must engage in further inquiries.

Let's start with a simple example. Assume a holder purchases, for $1,000, a five-year note that makes no interim payments. At maturity, the holder will receive $1,000 plus (or minus) $1,000 times the percentage change in the value of the S&P 500 from the issue date to the instrument's maturity, subject to a cap of $1,400 (the "Participation Note"). Because the percentage change can be negative, the holder's principal amount is at risk, and the holder could—theoretically—lose its entire investment in the Participation Note if the S&P 500 declines to zero. Accordingly, based on the authorities and reasoning discussed *supra* in Part II.b.i, the Participation Note likely should not be characterized as a Debt Note.[109]

Notes that are not fully principal-protected can include one of two types of *partial* principal-protection features: floors and buffers. A floor generally sets forth a minimum amount that the holder can receive at maturity, regardless of the performance of the Reference Asset. For example, the terms of the Participation Note in the example above could be adjusted to include a floor: the holder will receive at maturity $1,000 plus (or minus) $1,000 times the percentage change in the value of the S&P 500 from the issue date to the instrument's maturity, subject to a minimum amount payable at maturity of $500. By contrast, a buffer generally provides that the underlying Reference Asset can decline by a certain amount before the holder will lose their right to receive the principal amount. For example, the terms of the Participation Note in the example above could be adjusted to include a buffer—if the S&P 500 has declined from the issue date through the maturity date, but has not declined by more than 20%, the holder will receive $1,000 at maturity. If the S&P 500 has declined by more than 20%, the holder will lose $1.25 for every $1 decline in the S&P 500. Under the terms of this buffered note, unlike the floored note, the holder can lose their entire investment. The additional downside exposure below the buffer is known as "downside gearing." This type of buffer, which provides only temporary protection past which the holder can lose their entire principal amount, is sometimes referred to as a "hard buffer."

i. Level of Required Principal Risk & Risk of Loss Tests

Once a structured notes tax practitioner has concluded—at some level of comfort—that a note is *not* be treated as a Debt Note because it lacks the requisite principal protection, the next step is to conclude whether it has sufficient principal at risk to be treated as a non-debt prepaid derivative for U.S. federal income tax purposes at some level of comfort.

[109] Non-debt treatment is only "likely," because it is possible that the Participation Note might be treated as indebtedness for U.S. federal income tax purposes if it has a negligible risk of loss. *See infra* note 111 and accompanying text.

1. Market Practice

A. Significant Principal Meaningfully at Risk

The discussion *supra* in Part II.b.i is the baseline for understanding the amount of required risk for a note to be treated as *other than* debt for U.S. federal income tax purposes. Based on those authorities, structured note tax practitioners are generally comfortable concluding that a note is not a Debt Note if at least 50% of the holder's principal is at risk. Practitioners generally do not distinguish between buffers and floors for this purpose. This means that a note must have a buffer or floor that is less than 50% of its issue price to be treated as other than a Debt Note. In addition, some practitioners require some meaningful probability (*e.g.*, 1%) that a holder can lose at least 50% of its principal, but this practice is not universal.

B. Risk of Loss

In addition to the requirement that 50% of the holder's principal be at risk (sometimes with a meaningful probability of such risk coming to pass), practitioners often will require a meaningful probability that a holder can lose a substantial portion of their investment. The tests applied to arrive at this conclusion are generally referred to as "risk of loss" or "probability of loss" tests. For example, a structured notes tax practitioner might opine that a principal-at-risk note is "more likely than not" to be treated as a non-debt instrument for U.S. federal income tax purposes if there is a greater than 10% probability of the holder losing more than 10% of their investment.[110] If there is a greater than 7% risk of a greater than 10% loss, then the same advisor might opine that it is "reasonable" to treat the note as a non-debt instrument. There is no consensus on risk of loss tests, and market practice varies. Sometimes, tax disclosure for principal-at-risk notes will include a passage along the lines of the following: "The tax disclosure assumes that an investor in the notes will be subject to a significant risk that it will lose a significant amount of its investment in the notes."

Why are risk of loss tests necessary? After all, is it not sufficient for a note to have an adequate amount of principal at risk under the terms of the note to avoid treatment as a Debt Note? Unfortunately, the tax law in this area is not so simple. There is case law that stands for the proposition that an upfront payment of cash in exchange for the risk to receive a sufficiently predictable stream of cashflows gives rise to a debt instrument for U.S. federal income tax purposes, even in the absence of an unconditional promise by the issuer to pay a sum certain.[111]

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[110] *See, e.g.*, Treas. Reg. § 1.148-1(f)(4)(ii) (providing that that 10% is a "substantial amount"). *Cf.* Treas. Reg. § 1.279-3(c)(2) (defining "substantial amount" as 5%); Treas. Reg. § 1.280G-1 Q&A 29(a) (defining "substantial portion" as 1/3); Treas. Reg. § 15A.453-1(e)(5) (defining "substantial" as 20%).

[111] *See Mapco, Inc. v. United States*, 556 F.2d 1107 (Ct. Cl. 1977); *Hydrometals, Inc. v. Commissioner*, 31 T.C.M. (CCH) 1260 (1972); *Martin v. Commissioner*, 56 T.C. 1255 (1971). *See also Millenbach v. Commissioner*, 318 F.3d 924 (9th Cir. 2003) (holding that amounts received by the Oakland Raiders from the Los Angeles Memorial Coliseum Commission and the City of Irwindale were loans, and, as a result, were not taxable income to the Raiders in the year of receipt, because the Raiders had a "non-illusory, unconditional obligation to repay" the loan); GARLOCK, *supra* note 32, at ¶ 104.03[B]. *But see id.*, at ¶ 907.03[C]:

Farber notes as follows: "While the vast majority of the authorities supporting debt characterization involve . . . an unconditional right to a sum certain, absent the default bankruptcy of the issuer, several authorities suggest that it may be sufficient that the holder reasonably expects a return of, and perhaps on, his investment."[112] Alongside cases such as *Mapco* and *Hydrometals*, the Third Circuit's decision in *Merck & Co. v. United States*[113] created additional uncertainty regarding whether a financial instrument that does not unconditionally entitle the holder to a "sum certain" might nevertheless be treated as indebtedness for U.S. federal income tax purposes. In *Merck*, the taxpayer was a domestic corporation that assigned its positions in several interest rate swaps to two controlled foreign corporations ("CFCs"). Under the interest rate swaps, the domestic corporation was obligated to pay interest at fixed rates and was entitled to receive interest at floating rates. Economically, the CFCs made an upfront payment of cash to their domestic corporate parent in exchange for the right to earn the floating rate payments from the counterparty. The domestic corporation took the position that it was required to amortize the upfront payment from the CFCs into income over the period of the swap.[114] The Third Circuit disagreed and found that the transaction was, in substance, a loan from the CFCs to the domestic corporate parent. It held that the swaps were "deliberately planned, as a practical matter, so as to ultimately provide . . . repayment of the funds transferred . . . (plus interest)."[115] The court noted that the evidence in the case was "sufficient to show that . . . the parties intended to secure a repayment to [the CFCs] of the funds initially paid over to [the domestic corporate parent] that was, effectively if not explicitly, unconditional."[116] Accordingly, under this line of authority, both the terms of the note itself (*i.e.*, whether those terms call for repayment of a "sum certain") and economic reality (*i.e.*, the actual likelihood of repayment) must be taken into account.[117]

> Although it is undeniable that an unconditional right to receive a sum certain has been viewed as a hallmark of indebtedness, it is far from clear that traditional debt/equity authorities addressing whether an instrument is debt or equity of the issuer should be determinative whether an instrument whose principal is indexed to the value of property other than the issuer's stock (or stock of a related party) should be viewed as debt or something else. If all of the other indicia of indebtedness are present, there is no good reason why an instrument could not be viewed as debt merely because its principal amount is indexed. Moreover, as will be seen below, a conclusion that the instrument is not debt is problematic. While it is difficult to deny that, under current law, the better view is that the instrument is not a debt instrument, the IRS would appear to have the authority to reverse this conclusion through a regulation under section 1275 or other guidance, although it is highly unlikely to do so.

[112] Farber, *supra* note 6, at 665.

[113] 652 F.3d 475 (3rd Cir. 2011).

[114] *See* Notice 89-21, 1989-1 C.B. 651. Under current law, the payment would give rise to a deemed loan. *See* Treas. Reg. § 1.446-3(g)(4).

[115] *Merck v. United States*, 652 F.3d 475 (3rd Cir. 2011).

[116] *Id.*

[117] The cases discussed in this section of the paper generally involved circumstances in which taxpayers intended to avoid debt-for-tax treatment while entering into highly-structured transactions with a high likelihood of repayment but no unconditional promise of repayment. *See supra* note 111. Risk of loss tests, perhaps, are appropriate to ensure that a Prepaid Derivative Note would not be viewed in a similar regard.

In addition (or as an alternative to) the risk of loss tests discussed above, some structured notes tax practitioners evaluate the effective yield on an instrument to determine whether it should be treated as a Debt Note. Under these tests, for example, a practitioner would conclude that a structured note should not be treated as a Debt Note if the yield on the instrument is equal to or greater than 1.25 times the issuer's comparable yield. This line of testing is based on Code Sec. 1258. That provision, very generally, recharacterizes certain amounts that would otherwise be capital gain as ordinary income in the case of a "conversion transaction." A conversion transaction is a transaction that meets certain enumerated requirements and with respect to which substantially all of the taxpayer's expected return is attributable to the time value of the taxpayer's net investment.[118] If the yield on a principal-at-risk note is equal to or greater than 1.25 times the yield of the issuer's vanilla debt, some practitioners take that to mean that *less than* 80% of the yield of the note is attributable to the time value of money and the additional amounts paid are compensation for risk.[119] If this is the case, it is less likely that the structured note should be treated as a Debt Note—in exchange for the excess return, the holder must be undertaking material risk of nonrepayment, which is inconsistent with debt-for-tax treatment. Along similar lines, some practitioners note that, even when it applies, Code Sec. 1258 does not recharacterize a conversion transaction as debt for U.S. federal income tax purposes. Accordingly, if Code Sec. 1258 does not apply in the first instance to a structured note because the yield of the note is above the threshold, some conclude that, *a fortiori*, the instrument must not be debt for U.S. federal income tax purposes.[120]

2. "The Zone of Uncertainty"

What about notes that provide for principal protection of less than 85% but more than 50%? For example, assume that the Participation Note in the example in Part II.c *supra* includes a floor of 70% of the issue price—*i.e.*, the terms of the Participation Note provide that the holder will never receive at maturity an amount less than $700. These types of notes rest in a "zone of uncertainty." Some structured note tax practitioners are not comfortable treating these notes as Debt Notes because they do not include an unconditional promise to pay a sum certain, but they are also not comfortable treating them as a non-debt instrument. The same is true of notes that have less than 85% principal protection but also do not satisfy the relevant advisor's risk of loss criteria. In these cases, these practitioners might request that the issuer restructure the note to ensure that it falls cleanly into either the Debt Note or non-debt categories.

There are, however, exceptions. If a particular note has meaningful principal at risk under the terms of the note, but the *actual* risk of the holder losing a substantial portion of its investment is very low, some structured note tax practitioners are comfortable treating the note as a Debt Note;

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[118] *See* Code Sec. 1258(c).

[119] *See* Treas. Reg. § 1.731-2(c)(3)(i) (90% threshold for determining whether "substantially all" of an entity's assets consist of marketable securities or cash); Treas. Reg. § 1.448-1T(e)(4) (95% threshold in determining whether personal services constitute "substantially all" of a corporation's activities); Rev. Proc. 77-37, 1977-2 C.B. 568 (70% of gross assets and 90% of net assets are "substantially all" for purposes of the reorganization provisions).

[120] *See also* Farber, *supra* note 6, at 667–68 ("[T]he fact that the conversion transaction rules, which do not even recharacterize an instrument or group of instruments as indebtedness, do not apply could be seen as further support for the argument that the [note] is not indebtedness.").

because of the economics of such notes, they will almost invariably be treated as CPDIs. This is in part driven by the authorities on predictable payments discussed above[121] and, in part, driven by the fact that such treatment would be conservative, since CPDI treatment is generally disadvantageous for U.S. Holders.

ii. Prepaid Derivative Notes with No Interim Payments

This Part II.c.ii addresses the characterization and treatment of principal-at-risk notes that do not have interim payments—such notes pay all amounts to the holder only at maturity or upon an issuer's call.

1. Authority & Guidance

Thus far, we have established that a structured note that has sufficient principal at risk and satisfies the relevant risk of loss criteria is *not* treated as a Debt Note. This does not, however, answer the question of how it *should* be treated.[122]

In the case of structured notes with no interim payments that have sufficient principal at risk and satisfy the relevant advisor's risk of loss tests ("Prepaid Derivative Notes"), most issuers and their advisors treat the note, for U.S. federal income tax purposes, as a prepaid derivative contract treated as a non-debt "open transaction."[123] Accordingly, if the Participation Note in the example in Part II.c *supra* satisfied the advisor's risk of loss criteria, the issuer generally would treat it—at some level of comfort—as a prepaid derivative for U.S. federal income tax purposes.[124]

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[121] *See supra* note 111 and accompanying text.

[122] For additional discussion of this issue, see generally Farber, *supra* note 6.

[123] *See* Beeman, *supra* note 6, at 494 ("The ETN-offering materials themselves . . . 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.").

[124] Should Prepaid Derivative Notes with no interim payments generally be treated as notional principal contracts ("NPCs")? Under current law, an NPC is "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 upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts." Treas. Reg. § 1.446-3(c)(1)(i) (emphasis added). Because Prepaid Derivative Notes with no interim payments only involve a single payment by each party (*i.e.*, the initial investment by the holder and the payment at maturity by the issuer), it is difficult to conclude that they should be treated as NPCs. *See* Beeman, *supra* note 6, at 495 ("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.") (citing Notice 2001-44, 2001-2 C.B. 77). *See also* Prop. Reg. § 1.446-1(c)(iv) (2011) (excluding "forward contract[s]" from the definition of NPC). *But see* Prop. Reg. § 1.446-1(c)(ii) (2011) (proposing to define "payment" to include an "amount that is fixed on one date and paid or otherwise taken into account on a later date").

Several theories support this treatment. The key authority for "open transaction" treatment is *Burnet v. Logan*.[125] In that case, the taxpayer sold stock for cash and future contingent payments. The Supreme Court held that the transaction was "open" for U.S. federal income tax purposes because the obligation to make future payments was "wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty" and "had no ascertainable fair market value."[126] The "open transaction" doctrine ushered in by *Burnet v. Logan* "applies in deferred payment cases with so much uncertainty that it is impossible to determine whether any profit will be realized because income is contingent upon unknown factors."[127] In the case of Prepaid Derivative Notes, this criterion appears to be satisfied.[128] As the JCT has noted, "the existing treatment of a prepaid forward contract as an open transaction reflects the principle that income generally is not taxed until realization occurs (*e.g.*, upon a sale, exchange, or payment), when the amount of the income is known and the taxpayer has received cash with which to pay the tax."[129] There is a related line of authority for the proposition that advance proceeds for property (*i.e.*, the holder's initial payment to the issuer in exchange for the Prepaid Derivative Note) should be treated as deposits.[130]

Some practitioners believe that there is a second side to the open transaction doctrine. As Kristen M. Garry has articulated it, "[t]his other side of the open transaction doctrine is based on the inability of a taxpayer to know whether it will have a gain or loss upon receipt of money or property because its cost of completing the transaction is not yet known."[131] Whereas *Burnet v. Logan* and its progeny are premised on the notion that the holder of a speculative right to income should not be subject to current taxation, this side of the doctrine is based on the notion that the issuer of a transaction cannot determine the cost of the transaction. This, again, is generally true with respect to Prepaid Derivative Notes. As Farber has insightfully noted, "the taxation of indebtedness has historically turned on the question of whether the issuer's payments on the instrument constitute a predictable (and thus deductible) cost of doing business."[132] In the case of

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[125] 283 U.S. 404 (1936).

[126] *Id.*, at 413.

[127] *Patton v. United States*, No. 96-37T (Ct. Cl. 2001) (citing *Burnet. v. Logan*, 283 U.S. 404, 413 (1931)).

[128] Edward D. Kleinbard & Erika Nijenhuis, *Everything I Know About New Financial Products I Learned from DECS*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, at 10 (PLI 2010) [hereinafter DECS 2010] ("Non-debt treatment generally is consistent with the view that prepaid forward contracts are fundamentally risky financial instruments the contingent returns on which are not akin to interest or other time-value-of-money returns. Accordingly, prepaid forward contracts with respect to equities and commodities currently generally are taxed under the 'wait-and-see' method of tax accounting.")

[129] JCT Report, *supra* note 2, at 30.

[130] *See, e.g.*, *Commissioner v. Indianapolis Power & Light Company*, 493 U.S. 203 (1990); Rev. Rul. 73-369, 1973-2 C.B. 155; Rev. Rul. 69-93, 1969-1 C.B. 139.

[131] Kristen M. Garry, *"Open Transaction": A Doctrine That Continues to Have Vitality*, 8 J. TAX'N FIN. PRODS. 53, 53 (2010) ("As discussed below, this side of the open transaction doctrine has been applied to transactions in options, short sales and other financial products and continues to have vitality.").

[132] Farber, *supra* note 6, at 663.

a Prepaid Derivative Note, there is no guarantee that the issuer will be required to pay any particular amount to the holder—there is no "predictable . . . cost of doing business." As a result, under *either* side of the open transaction doctrine, it would be inappropriate to treat a Prepaid Derivative Note as indebtedness for U.S. federal income tax purposes.

Second, Prepaid Derivative Notes could be viewed as forward contracts, or as very closely analogous thereto. A forward contract generally is a bilateral executory contract in which one party agrees to purchase an asset on a future date for a specific forward purchase price to be paid in the future.[133] A forward contract is generally accounted for as an open transaction for U.S. federal income tax purposes, and no gain or loss is taken into account until the forward contract is settled or otherwise disposed of or terminated.[134] The primary differences between a typical Prepaid Derivative Note and conventional forward contract are that the former is (i) in all cases a prepaid instrument and (ii) in many cases "non-linear"[135]—*i.e.*, provides for a payout profile that is not one-to-one with respect to changes in the value of the underlying Reference Asset. The fact that the Prepaid Derivative Note is "prepaid" should not affect its tax characterization.[136] Along similar lines, there is authority for the proposition that the discount embedded within a prepaid forward contract does not give rise to interest for U.S. federal income tax purposes.[137] Moreover, the payout profile of a Prepaid Derivative Note being non-linear should not be relevant to whether the analogy to a forward contract is valid for purposes of determining that a prepaid Derivative Note, like a forward contract, should be accounted for as an open transaction for U.S. federal income tax purposes.[138] A non-linear derivative presents an equally compelling instance of a risky contract that should be treated as an open transaction.

Third, Rev. Rul. 2003-7,[139] which addressed a variable prepaid forward contract ("VPF"), can be read as supporting the treatment of a Prepaid Derivative Note as an open transaction. In the

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[133] *See* Notice 2008-2, 2008-2 I.R.B. (defining "forward contract").

[134] *See Commissioner v. N. Tex. Lumber Co.*, 281 U.S. 11 (1930); *Rich Lumber Co., Inc. v. United States*, 237 F.2d 424 (1st Cir. 1956); *Commissioner v. Segall*, 114 F.2d 706 (6th Cir. 1940); *Stanley v. United States*, 436 F. Supp. 581 (N.D. Miss. 1977).

[135] Such a note may also be called a non–delta-one note. *Cf.* Treas. Reg. § 1.871-15(g) (defining "delta" for purposes of Code Sec. 871(m) as the ratio of the change in the fair market value of a derivative to a small change in the fair market value of the number of shares of the underlying security). Note that some Prepaid Derivative Notes are delta one; in the case of such notes, it is even easier to conclude that they should be taxed as forward contracts.

[136] *See* JCT Report, *supra* note 2, at 17 ("The fact that a forward contract calls for payment by one party to the other party at the time the contract is executed has not been treated as changing the tax treatment of the contract.").

[137] *Baltimore & Ohio R.R. Co. v. Commissioner*, 78 F.2d 460 (4th Cir. 1935). *See also* Weisbach, *supra* note 14, at 498 ("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."). *See generally* Edward D. Kleinbard & Erika Nijenhuis, *Everything I Know About New Financial Products I Learned from DECS*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS n.66 (PLI 1999). Note that the foregoing source is an earlier version of the article cited at *supra* note 128.

[138] Rev. Rul. 2003-7, discussed immediately below, generally supports this argument.

[139] 2003-1 C.B. 363.

ruling, the IRS concluded that a VPF—a non-linear prepaid derivative—that referenced stock held by the issuer of the VPF did not give rise to a sale of the stock under either the constructive sale rules of Code Sec. 1259 or under common law constructive sale principles. Some, including the JCT, read the ruling as suggesting that the VPF should be taxed as an open transaction for U.S. federal income tax purposes and that Prepaid Derivative Notes should be taxed in similar fashion.[140] At a time when the government was issuing proposals to change the open transaction treatment of Prepaid Derivative Notes, Beeman and Keinan wrote the following: "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."[141] On the other hand, some view the ruling as under-determinative: These practitioners and commentators believe that the ruling solely concludes that entering into the VPF did not result in a constructive sale of the taxpayer's shares without addressing directly how the VPF itself should be taxed.[142] Nevertheless, the prevailing view appears to be that the ruling implies that the VPF was an open transaction.

Fourth, IRS Notice 2008-2 (the "Notice") strongly suggests that instruments like Prepaid Derivative Notes should be treated as open transactions for U.S. federal income tax purposes.[143] In 2007, the IRS released Notice 2008-2,[144] which states that the IRS and the Treasury were, at least at the time, considering issuing guidance addressing prepaid forward contracts (*i.e.*, Prepaid Derivative Notes) and ETNs. The Notice delineates its scope by stating that these transactions "resemble typical forward contracts, but the purchase price is paid in advance of future delivery or cash settlement" and thus "typically involve an initial payment by one party in exchange for a promise of either (i) a future delivery of a particular asset or group of assets (for example, stocks or commodities), or (ii) a future payment determined exclusively by reference to the value of such assets."[145] Thus, the Notice clearly captures most Prepaid Derivative Notes within its scope. Crucially, the Notice provides that the IRS and Treasury are considering whether "the parties to

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[140] *See* JCT Report, *supra* note 2, at 28 ("Nonetheless, the prevailing view among issuers of [Prepaid Derivative Notes] and their counsel is that these securities should be treated for tax purposes as prepaid forward contracts. This conclusion is based on analogy to the treatment of other prepaid forward contracts that have been issued in the capital markets in recent years.") (citing Rev. Rul. 2003-7, 2003-1 C.B. 363); Beeman, *supra* note 6, at 495 ("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.").

[141] Beeman, *supra* note 6, at 497; Farber, *supra* note 6, at 662 ("Certainly, the unstated implication of the ruling is that no [income from the prepayment or imputation of interest] arose from the contract, and most would agree that this is the correct result under current law.").

[142] *See* Farber, *supra* note 6, at 662 ("The Service itself has called this instrument an 'open transaction,' but was likely referring to the fact that it did not cause a disposition, or a constructive disposition, of the underlying stock that was being hedged; the ruling makes no mention of how the contract itself should be taxed.").

[143] Congress has also attempted to craft a regime requiring imputation of income on Prepaid Derivative Notes, which also implies that—under current law—such notes should be treated as open transactions. On December 19, 2007, Representative Richard Neal introduced H.R. 4912, which would introduce new Code Sec. 1289. Proposed Code Sec. 1289 generally would require holders of prepaid derivative contracts (*i.e.*, Prepaid Derivative Notes) to accrue income on such contracts on a current basis. Like Notice 2008-2, proposed Code Sec. 1289 strongly suggests that no such accrual is required under current law. For a thorough analysis of H.R. 4912, see Beeman, *supra* note 6, at 490–94.

[144] 2008-2 I.R.B.

[145] *Id.*

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."[146] The Notice implicitly confirms that no such current accrual is required under current law and thus current law supports the treatment of such instruments as open transactions for U.S. federal income tax purposes.[147]

Fifth, in preambles to the current final 1993 regulations and 2004 proposed regulations governing the taxation of NPCs, the IRS appeared to imply that prepaid forward contracts are not subject to current accrual of income or deduction.[148] In Treasury Decision 8491, which ushered in the current final NPC regulations, the IRS said that it was, at least in 1993, "working on a project dealing more generally with . . . prepaid financial instruments . . . and may amend these [NPC] regulations to accord with the decisions reached in that project." Accordingly, the IRS chose not to extend the rules in the NPC regulations that impute interest on prepaid instruments to such contracts. Similarly, in the preamble to the proposed 2004 NPC regulations, the IRS said the following:

> The IRS and Treasury understand that . . . timing issues [similar to those that exist for NPCs with contingent nonperiodic payments] exist for other types of derivative investments, like bullet swaps and prepaid forward contracts. Although the application of the proposed regulations to these types of transactions may achieve appropriate timing, the application of these rules to investments other than NPCs could present a number of issues not directly addressed by the rules contained in these proposed regulations. The expansion of the scope of these proposed regulations to contracts other than NPCs is not being proposed at this time so as not to delay the publication of the proposed regulations.[149]

The NPC preambles cited above imply that, under current law, Prepaid Derivative Notes are not subject to an accrual regime. Accordingly, they should be accounted for as open transactions for U.S. federal income tax purposes.

Sixth, Prepaid Derivative Notes can be analogized to options which, essentially, are accounted for as open transactions for U.S. federal income tax purposes.[150] In fact, disclosure for Prepaid Derivative Notes sometimes includes a statement along the lines of the following:

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[146] *Id.*

[147] U.S. tax disclosure for most Prepaid Derivative Notes generally highlights the Notice and the risk that any guidance under the Notice could impact such notes.

[148] *See* T.D. 8491, 1993-2 C.B. 215; Prop. Reg. § 1.446-3(g), 69 FED. REG. 8886, 8892 (2004). *See* Farber, *supra* note 6, at 637 n.3 (citing these preambles for the proposition that "[i]t seems well established under current law that, absent a conclusion that the instrument is or includes an element of indebtedness, no such regime [of requiring accrual of income or expense] exists."); *id.*, at 662 (citing the same to support the view that no accrual of income or expense is "the correct result under current law"). The author is grateful to Lucy Farr for clarifying this line of argument.

[149] Prop. Reg. § 1.446-3(g), 69 FED. REG. 8886, 8892 (2004).

[150] *See Virginia Iron Coal & Coke Co. v. Commissioner*, 99 F.2d 919, 921 (4th Cir. 1938) ("[A]t the time the payments were made it was impossible to determine whether they were taxable or not."). *See also* Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 CB 279.

"Payments on the notes may be viewed as economically equivalent to a combination of a non-interest-bearing bond purchased by the holder and one or more options entered into between the holder and the issuer." Cases have defined an "option" for U.S. federal income tax purposes as a contract that satisfies two requirements: (i) a continuing offer to do or to forbear from doing something and (ii) an agreement to leave this offer open for a specified or reasonable period of time.[151] Even though they can be dissolved into a combination of options and other financial instruments, most Prepaid Derivative Notes do not necessarily easily satisfy this definition of an "option." Nevertheless, their tax treatment may be analogous. The tax treatment of options, like the tax treatment of forward contracts—is rooted in the open transaction doctrine.[152] Just as with an option, from the time the holder purchases the Prepaid Derivative Note until maturity, it is generally impossible to compute properly the taxable income that should be included by the holder and the issuer. Thus, this justification for the tax treatment of options provides a sound analogy for why Prepaid Derivative Notes should be accounted for as open transactions.

Even if a Prepaid Derivative Note is properly treated as an "open transaction" for U.S. federal income tax purposes, it is important to analyze whether and how such treatment is impacted by *Schlude* and its progeny, which are cases holding that taxpayers are required to include in income advance payments for goods or services. The better view is that this body of case law should not apply to financial instruments like Prepaid Derivative Notes. Under the line of cases that includes *Schlude v. Commissioner*,[153] the courts have held that a prepayment for goods or services must be included in income by an accrual basis taxpayer at the earliest of (i) when the taxpayer earns the right to be paid through performance (the "all-events test"), (ii) when payment is due to the taxpayer, or (iii) when the taxpayer is paid.[154] However, the weight of commentary and practitioner opinion is that these cases should not apply to financial instruments governed by open transaction principles. As one article notes, "The application of *Schlude* principles to financial instruments should be viewed with some caution, however. . . . The logic of *Schlude* and *Hagen Advertising* does not apply to transactions in which those ordinary tax rules apply . . . ."[155] In Notice 89-21,[156] the IRS said that "[t]he method of accounting prescribed in cases such as *Schlude* . . . does not clearly reflect income in the case of notional principal products." Notice 89-21 distinguished *Schlude* and concluded that current inclusion of a lump-sum payment with respect to an NPC did not clearly reflect income. One commentator interprets the Notice as concluding

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[151] *See, e.g.*, *Saviano v. Commissioner*, 80 T.C. 955, 969 (1983), *aff'd* 765 F.2d 643 (7th Cir. 1985); *Koch v. Commissioner*, 67 T.C. 71, 82 (1976), *acq.* 1980-2 C.B. 1; *Drake v. Commissioner*, 3 T.C. 33 (1944), *aff'd* 145 F.2d 365 (10th Cir. 1944).

[152] *See, e.g.*, *Baird v. United States*, 65 F.2d 911, 912 (5th Cir. 1933) ("It is apparent that the right of the Baird Partnership to the $500,000 was in doubt in 1919 and the partnership could not have been compelled to account for it as income for that year.").

[153] 372 U.S. 128 (1963).

[154] *See also American Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957); *American Automobile Association v. United States*, 367 U.S. 687 (1961); *Hagen Advertising Displays, Inc. v. Commissioner*, 47 T.C. 139 (1966).

[155] DECS 2010, *supra* note 128, at 7–8 n.23.

[156] 1989-1 C.B. 651.

that *Schlude* and its progeny are distinguishable from instruments like Prepaid Derivative Notes "because the timing of performance in the [cases] was not fixed whereas under the [derivative] contract, the dates for payment are fixed."[157] Accordingly, structured notes tax practitioners generally view the *Schlude* line of cases as inapplicable to Prepaid Derivative Notes.[158]

2. Market Practice for U.S. Holders and Non-U.S. Holders

Assuming that a Prepaid Derivative Note is properly treated as a prepaid derivative that is open transaction for U.S. federal income tax purposes, U.S. Holders generally should not include any gain, loss, income, or deduction until disposition. Upon a sale, exchange, or retirement of the Prepaid Derivative Note, U.S. Holders generally recognize capital gain or loss equal to the difference between the amount realized on the sale, exchange or retirement and the U.S. Holder's tax basis in the Prepaid Derivative Note. This gain or loss generally will be long-term capital gain or loss if, at the time of the sale, exchange, or retirement, the U.S. Holder held the note for more than one year, and short-term capital gain or loss otherwise.

Proceeds from the sale, exchange, or retirement of a Prepaid Derivative Note are generally U.S.–tax-free for Non-U.S. Holders both because such proceeds do not constitute FDAP[159] and because such proceeds should be non-U.S. source income.[160]

iii. Prepaid Derivative Notes with Interim Payments—a/k/a At-Risk Coupon Notes

1. Overview of At-Risk Coupon Notes

What if a structured note is a Prepaid Derivative Note but makes interim payments to the holder (an "At-Risk Coupon Note")? These instruments come in many varieties and flavors. For example, coupons can be fixed or contingent; the final payment at maturity could provide for upside participation[161] or not; the maturity payment can include caps, floors, buffers, or leverage. To cover maximal ground, however, the discussion in this Part II.c.iii extends to any note that (i) pays either fixed or contingent coupons, (ii) offers sufficiently low principal protection that the

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[157] Albert J. Vernacchio, *The Taxation of Notional Principal Contracts after Notice 89-21: A Clear Reflection of Income or an Abuse of the Commissioner's Discretion?*, 28 DUQ. L. REV. 515, 530 (1990). *See also Artnell Co. v. Comm'r*, 400 F.2d 981 (7th Cir. 1968).

[158] *See* Farber, *supra* note 6, at 669 ("Here, however, the [Prepaid Derivative Note] does not involve purchases or sales of goods or services but a capital transaction. Indeed, the instrument bears some similarity to a number of traditional instruments that have been treated as pure open transactions."); Weisbach, *supra* note 14, at 498 n.25 ("Moreover, given the liquidity of financial instruments and the corresponding arbitrage potential, the accuracy of the taxation may have different considerations for financial transactions than in other contexts, such as the dance lessons considered in Schlude.").

[159] *See* Treas. Reg. § 1.1441-2(b)(2)(i).

[160] *See* Code Sec. 865(a).

[161] For example, an At-Risk Coupon Note could provide for fixed coupon payments over the term of the note and a final maturity payment that provides for 1-to-1 (*i.e.*, delta one) exposure to the Reference Asset.

issuer does not intend to treat it as a Debt Note, and (iii) satisfies the applicable risk of loss standards.

Let's start with a simple example of an At-Risk Coupon Note. Assume a holder purchases, for $1,000, a five-year note that pays an annual coupon of 5%. At maturity, the holder will receive $1,000 plus (or minus) $1,000 times the percentage change in the value of the S&P 500 from the issue date to the instrument's maturity. How should the holder be taxed?

A. Authority & Guidance—The Story of DECS

There is very little guidance or authority on how the holder of an At-Risk Coupon Note should be taxed. Perhaps the best place to start is with one of the most interesting financial products of all time and a precursor to At-Risk Coupon Notes: DECS.

DECS is an acronym for "Debt Exchangeable for Common Stock" and was a service mark coined by Salomon Bros. DECS were all the rage from 1993 until the early 2000s. Issuers loved DECS because DECS allowed them to hedge and monetize portfolio stock investments; holders loved DECS because they provided for exposure to the stock and paid a coupon that exceeded the dividend yield; tax lawyers loved DECS because they raised fascinating issues; and investment bankers loved DECS for reasons that can be left to the reader's imagination. Sadly, like many beloved 1990s trends, DECS died an untimely death in the early 2000s. The demise of DECS resulted from a combination of the IRS's expanded interpretation of the straddle rules and the enactment of Code Sec. 163(*l*).[162] Nevertheless, the spirit of DECS lives on in At-Risk Coupon Notes,[163] so we are fortunate to have the opportunity to analyze these fascinating creatures. Note, however, that since others have done a finer job of discussing the taxation of DECS than the author could ever hope to do,[164] the discussion below is only a cursory summary, focused on describing the elements of DECS that are most relevant to the taxation of At-Risk Coupon Notes.

In a typical DECS transaction, the holder would contribute cash to an issuer in exchange for the DECS. DECS generally provided for periodic payments at a fixed "interest" rate and for a payment at maturity linked to a share of stock of a corporation unrelated to the DECS issuer. To summarize heroically, under the terms of the DECS, the holder was exposed to the full downside risk of the decline of the reference stock and would share (alongside the DECS issuer) in any appreciation of the reference stock. The DECS issuer could, at its option, settle the DECS either in cash or physically (by delivering the requisite number of shares of the reference stock).

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[162] *See generally* DECS 2010, *supra* note 128; GARLOCK, *supra* note 32, at ¶ 907.03[4] (noting that the enactment of Code Sec. 163(*l*) was the "final nail in the coffin" of DECS).

[163] Banks that issue At-Risk Coupon Notes are generally not concerned about the straddle rules, because they rely on the Code Sec. 1221 hedging identification rules, see Code Sec. 1092(e), and/or mark-to-market tax accounting. Moreover, these banks are "dealers in securities" under Code Sec. 475 and thus are exempt from the application of Code Sec. 163(*l*). *See* Code Sec. 163(*l*)(5).

[164] For the definitive commentary on DECS, including a riveting discussion of the DECS FSAs discussed below, see DECS 2010, *supra* note 128. *See also* Farber, *supra* note 6, at 651–52; GARLOCK, *supra* note 32, at ¶ 907.03[C].

Issuers adopted varying characterizations of DECS for U.S. federal income tax purposes. At least one issuer treated DECS as debt for U.S. federal income tax purposes.[165] Several issuers characterized DECS as "pre-paid income-bearing derivative contract[s]," the coupons on which were ordinary income to U.S. Holders includible based on their method of accounting.[166] Others treated DECS as bifurcated into a debt instrument (or a deposit) and a derivative (*i.e.*, a forward contract or option).[167] Bifurcation (or disaggregation) is discussed in Part II.c.iii.2 *infra*. This approach presented issuers and holders with the problem of how to allocate the coupon between the two components.[168]

The IRS addressed DECS in three field service advice memoranda (the "DECS FSAs").[169] As one would expect based on the authorities discussed in Part II.b.i.2 *supra*, the DECS FSAs concluded that the DECS were not debt for U.S. federal income tax purposes because they did not provide for an unconditional payment of a sum certain—the investor, theoretically, could receive nothing at maturity if the reference stock declined to zero.[170] In addressing how the DECS *should* be characterized for U.S. federal income tax purposes, the IRS considered the following possibilities: (i) a "collar" (*i.e.*, a combination of a put option written by, and a call option purchased by, the issuer), (ii) an NPC, (iii) a prepaid forward, (iv) a *sui generis* financial instrument "subject to [its] own unique rules under the tax system," or (v) as bifurcated into components. Tragically, the DECS FSAs do not express the IRS's view on which of these characterizations is correct; the DECS FSAs were focused on the application of the straddle rules to DECS, which did not depend on how the DECS were characterized for U.S. federal income tax purposes.[171] Nevertheless, the history of DECS and the DECS FSAs give some clues as to how issuers and holders should treat At-Risk Coupon Notes.

B. Market Practice

i. Income-Bearing Prepaid Derivative

Currently—except for reverse convertibles ("RevCons") and some credit-linked notes ("CLNs") (each of which is discussed *infra*)—most structured note tax practitioners treat At-Risk Coupon Notes as income-bearing prepaid derivative contracts. As the DECS FSAs concluded, Debt Note treatment seems inappropriate because At-Risk Coupon Notes do not provide for an

[165] FSA 199940007 ("The taxpayer treated the Instruments as indebtedness for federal income tax purposes . . . .").

[166] Prospectus Supplement, Barclays Bank PLC, Global Medium-Term Notes, Series A, Yield Enhanced Equity Linked Debt Securities (YEELDS) (July 19, 2013); Prospectus Supplement, The Goldman Sachs Group, Inc., Medium-Term Notes Series D, $29,874,000 10% Mandatory Exchangeable Notes due 2013 (Linked to the Common Stock of Apple Inc.) (Jan. 22, 2013).

[167] *See* GARLOCK, *supra* note 32, at ¶ 907.03[C].

[168] *See id*.

[169] *See* FSA 199940007; FSA 200131015; FSA 200150012.

[170] *See, e.g.*, FSA 200150012 ("Based on the facts of this case and the factors described above, the Instruments should not be treated as debt for federal income tax purposes.").

[171] See, *e.g.*, FSA 200150012 ("Under any of these alternatives, the exception of § 1092(d)(3)(B)(i)(II) will apply so that [the issuer's] position in the Instruments and the [reference] stock will be a straddle.").

unconditional payment of a sum certain.[172] Some advisors believe that disaggregation of the At-Risk Coupon Notes into components, although potentially viable, is difficult, because the At-Risk Coupon Notes have complex economic features.[173] As a result, the most common approach is to treat At-Risk Coupon Notes as income-bearing prepaid derivative contracts.

(1) U.S. Holders

Under this treatment, U.S. Holders should include coupon payments on the At-Risk Coupon Notes as ordinary income (but not interest, since the At-Risk Coupon Notes are not debt) at the time such coupons are received or accrued in accordance with their regular method of accounting for U.S. federal income tax purposes.[174] The DECS FSAs suggest that this is the correct treatment of the coupons: the DECS FSAs assumed that DECS issuer could—but for the application of the straddle rules—deduct the coupon.[175] Fundamental symmetry[176] implies that the holder of the DECS would be required to include the coupon in income. Thus, the DECS FSAs imply that the coupon paid with respect to an At-Risk Coupon Note should be includible by a U.S. Holder as ordinary income on a current basis.[177]

Upon a sale, exchange, or retirement of an At-Risk Coupon Note, U.S. Holders generally recognize capital gain or loss equal to the difference between the amount realized on the sale, exchange, or retirement (other than amounts attributable to accrued but unpaid coupons) and the

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[172] See *supra* notes 26 and 170 and accompanying text.

[173] Disaggregation is discussed in more detail in Part II.c.iii.2 *infra*. *See* Rev. Rul. 2003-97, I.R.B. 2003-34 (listing the features of an instrument similar to a DECS, including separate transferability of the components, which would cause it to be treated as two separate instruments for U.S. federal income tax purposes). *See also* Farber, *supra* note 6, at 692 n.162 ("The logic of Revenue Ruling 2003-97 . . . would imply by negative inference that a nonseparable instrument . . . does not involve the payment or imputation of interest between the parties.").

[174] Note, however, that arguments may be available that the coupons are *not* currently includible by holders and that the At-Risk Coupon Note, including the coupons, should be treated in its entirety as an "open transaction" for U.S. federal income tax purposes. The theory here is that it makes little sense to force the holder to pay tax on the coupons while it is possible that the holder could lose its entire investment in the note (and thus suffer an overall economic loss): the outcome will be unknown until the At-Risk Coupon Note matures or the holder disposes of it, so it makes sense to treat the transaction as "open." *See* Am. Bar Ass'n, *Comments Concerning Notice 2008-2*, at 24 (Nov. 18, 2002) ("In our judgment, [treating periodic payments as a return of basis] appears fairly consistent with a realization-based approach to the contract. If this approach were adopted, in addition to the results set forth above, the periodic payments generally would not be subject to U.S. withholding tax even if paid to a non-U.S. person.").

[175] *See* FSA 199940007; FSA 200131015; FSA 200150012.

[176] Unfortunately, the tax law does not always provide for the symmetrical treatment of issuers and holders. *See, e.g.*, Code Sec. 163(*l*) (denying the issuer a deduction for interest paid with respect to equity-like debt without affecting the holder's obligation to include the interest in income). The author generally agrees with Farber that "it is desirable to tax holders and issuers . . . symmetrically." *See* Farber *supra* note 6, at 638.

[177] *See* Farber *supra* note 6, at 651 n.52. Although one might be tempted to argue that the ordinary income treatment of such coupons is inappropriate because such coupons often are linked to the performance of the Reference Asset (which would be a capital asset in the hands of a U.S. Holder), it would be hard to conclude that the coupons satisfy the "sale or exchange" requirement for capital gain treatment. *See* Code Sec. 1222 (generally requiring a "sale or exchange" for capital gain or loss treatment). *See also* TAM 199730007 (concluding that periodic NPC payments should be ordinary income even though they are linked to changes in the value of a capital asset).

U.S. Holder's tax basis in the At-Risk Coupon Note. For example, if a U.S. Holder purchased an At-Risk Coupon Note for $1,000 and receives $630 at maturity, $30 of which is attributable to an accrued but unpaid coupon, the U.S. Holder should recognize $30 of ordinary income and a $400 capital loss ($1,000 minus $600). It is worth pausing on why amounts received by a holder upon a sale, exchange, or retirement that are attributable to accrued but unpaid coupons are not eligible for capital gain treatment. This conclusion is based on an analogy to debt instruments. In the case of a debt instrument, Treas. Reg. § 1.61-7(d) provides that "when bonds are sold between interest dates, part of the sale price represents interest accrued to the date of the sale and must be reported as interest income." In the absence of any authority or guidance to the contrary, it is sensible to follow this approach for accrued but unpaid coupons with respect to an At-Risk Coupon Note. Gain or loss from an At-Risk Coupon Note generally should be long-term capital gain or loss if, at the time of the sale, exchange, or retirement, the U.S. Holder held the note for more than one year and short-term capital gain or loss otherwise. Tax disclosure for At-Risk Coupon Notes often includes a disclaimer that, although uncertain, it is possible that proceeds received from a disposition of the At-Risk Coupon Notes prior to a coupon payment date that could be attributed to an expected coupon could be treated as ordinary income.

(2) Non-U.S. Holders

As with Prepaid Derivative Notes, proceeds from the sale, exchange, or retirement of an At-Risk Coupon Note are generally U.S.–tax-free for Non-U.S. Holders, both because such proceeds do not constitute FDAP[178] and because such proceeds should be non-U.S. source income.[179]

However, the tax treatment of *coupons* paid to Non-U.S. Holders of At-Risk Coupon Notes is significantly more complex. Let's assume for simplicity that the issuer of the At-Risk Coupon Note is a domestic corporation for U.S. federal income tax purposes. Should such payments be treated as U.S. source FDAP subject to 30% U.S. withholding tax? Coupons paid on an At-Risk Coupon Note almost certainly constitute FDAP. Treasury regulations generally provide that "all income included in gross income under Code Sec. 61" is FDAP, and the only clear exclusion is for "gains derived from the sale of property (including market discount and option premiums)."[180] The real question is whether the coupons are U.S. source income.

There is no clearly applicable authority for how coupons paid on instruments like At-Risk Coupon Notes should be sourced. When faced with income of this sort, courts generally source the income by analogy to other categories of income for which sourcing rules exist.[181] The leading

[178] *See* Treas. Reg. § 1.1441-2(b)(2)(i).

[179] *See* Code Sec. 865(a).

[180] Treas. Reg. § 1.1441-2(b)(1)(i) & Treas. Reg. § 1.1441-2(b)(2)(i). *See also Commissioner v. Wodehouse*, 337 U.S. 369 (1949).

[181] In the author's view, the definitive commentary on this issue is Andrew Walker, *Exceptions in Search of a Rule: The Source and Taxability of "None of the Above" Income*, COLUM. L. SCH. TAX POL'Y COLLOQUIUM (Oct. 8, 2009).

case for this approach is *Bank of America v. United States*.[182] In *Bank of America*, the Court of Claims held that acceptance and confirmation commissions were foreign source income by analogizing them to interest. This analogy was based on the court's conclusion that the commissions compensated the recipient bank for assuming the credit risk of foreign banks. Numerous administrative pronouncements have followed the *Bank of America* approach, and it is fair to say that sourcing by analogy is the dominant analytical approach when faced with novel sourcing questions.[183]

If a tax advisor is keen to conclude that a particular type of income is non-U.S. source, and thus not subject to U.S. withholding tax, it is important to exercise caution. Advisors grappling with sourcing by analogy must contend with Rev. Rul. 2004-75.[184] That revenue ruling represents the *ne plus ultra* of treating FDAP as U.S. source income, because the IRS concluded that income was U.S. source notwithstanding a very tenuous connection between the income and the United States. In Rev. Rul. 2004-75, the IRS ruled that income received by *nonresident aliens* under life insurance and annuity contracts issued by a *foreign branch* of a U.S. life insurance company was U.S. source income that was subject to 30% withholding tax. The IRS asserted that the income was analogous to interest, dividends, and earnings and accretions on pension fund assets. Since the policy issuer was a domestic corporation (and notwithstanding the fact that the nonresident alien was actually transacting with a foreign branch), the IRS concluded that the income was U.S. source. Accordingly, any advisor attempting to conclude that payments made by a domestic corporation with respect to an ambiguous financial instrument are foreign source should proceed with care.

How should coupons paid with respect to At-Risk Coupon Notes be sourced by analogy? Putting aside the argument that At-Risk Coupon Notes may be NPCs (discussed *infra* in Part II.c.iii.1.B.ii), there are two potential conceptual approaches. The first approach would acknowledge that no sourcing rule exists for income-bearing prepaid derivatives and would examine every conceivable alternative characterization of the At-Risk Coupon Note for which a sourcing rule exists to find the appropriate analogy for each such characterization. Under this line of analysis, an At-Risk Coupon Note could be characterized as a debt instrument (although this is unlikely), a forward contract, an option or a combination thereof, an NPC, or an instrument disaggregated into a deposit and a forward or option.[185] Under this approach, only sourcing by analogy to a debt instrument could conceivably result in the coupon being treated as U.S. source income.[186] Income from a forward contract or option generally would be foreign source if paid to a non-"United States person" (as defined for U.S. federal income tax purposes),[187] and the same is

[182] 680 F.2d 142 (Ct. Cl. 1982). *See also Howkins v. Commissioner*, 49 T.C. 689 (1968); *Clayton v. United States*, 33 Fed. Cl. 628 (1995).

[183] See, *e.g.*, Rev. Rul. 2004-75, 2004-31 I.R.B 109; FSA 200147003; FSA 200031005.

[184] 2004-31 IRB 109.

[185] Disaggregation is discussed in Part II.c.iii.2 *infra*.

[186] *See* Code Sec. 865(a); Treas. Reg. § 1.863-7.

[187] *See* Code Sec. 865(a).

true of NPC income.[188] There is no reason to believe that an At-Risk Coupon Note is more analogous to a debt instrument than it is to a derivative that exposes the holder to downside risk. After all, the defining feature of the At-Risk Coupon Note is that it is, unlike a debt instrument, "at risk." Moreover, if the At-Risk Coupon Note were *actually* characterized as a debt instrument (or as a disaggregated instrument consisting of debt and a forward contract or option), the coupon (or the portion thereof that corresponds to interest) would generally qualify for the portfolio interest exemption (and any component(s) relating to the forward or option would be non-U.S. source non-FDAP). Accordingly, one might argue that, if the coupon is sourced *by analogy* to interest, the portfolio interest exemption should apply to the coupon, and some structured note tax practitioners indeed adopt this position.

Under the second conceptual approach, one would examine the economic features of the At-Risk Coupon Note, without examining the proper characterization of the instrument, to identify the predominant economic feature and source the coupon accordingly. This analysis would turn on the precise economics of the At-Risk Coupon Note at issue. It is difficult to summarize that analysis here, since At-Risk Coupon Notes come in many varieties and flavors. Nevertheless, one can distill two unifying principles. First, At-Risk Coupon Notes generally include a time value component to compensate the holder for the issue price. This feature would point towards sourcing the coupons by analogy to interest (and thus sourcing them based on the residence of the payor); accordingly, coupons paid by an issuer that is a domestic corporation would generally be U.S. source. Second, At-Risk Coupon Notes generally also include compensation for risk with respect to the Reference Asset. Financial transactions that compensate a holder for risk with respect to reference property include forwards, options, and NPCs, all of which are sourced based on the residence of the recipient.[189] The applicable law on sourcing is that payments are sourced based on the *predominant* economic element of the payment.[190] Some advisors are able to conclude that the predominant economic element of an At-Risk Coupon Note is compensation for equity risk.[191] Note that, although this analysis disaggregates the At-Risk Coupon Note into its economic elements *for purposes of determining the source of the coupons*, it is distinguishable from a true disaggregation approach that dismantles the At-Risk Coupon Note into its economic components for *all U.S. federal income tax purposes*.

Thus, the two potential approaches above both could potentially lead to a conclusion that coupons paid on an At-Risk Coupon Note issued by a domestic corporation would not be U.S.

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[188] *See* Treas. Reg. § 1.863-7.

[189] *See supra* note 186.

[190] *See Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982) (concluding that payments should be sourced by analogy to interest, not services, based on "the predominant feature" of the relevant contracts).

[191] A more sophisticated version of this approach would compare the coupon payable on the At-Risk Coupon Note with the issuer's comparable yield (*i.e.*, the yield at which the issuer would issue a non-contingent fixed rate debt instrument with terms and conditions similar to the actual instrument) to confirm that the At-Risk Coupon Note coupon is exceeds the comparable yield by more than 50%. This would serve to demonstrate that the predominant nature of the holder's yield is compensation for risk, not compensation for the time value of money. *See generally* Prop. Reg. § 1.385-5 (concluding that an instrument should be properly treated as debt for U.S. federal income tax purposes if the present value of noncontingent principal and interest payments is 50% or more of the fair market value of the instrument).

source when paid to Non-U.S. Holders. Nevertheless, in what may be viewed as an abundance of caution, tax disclosure for many At-Risk Coupon Notes issued by a domestic corporation (or by an issuer that otherwise pays U.S. source interest) provides that the issuer, if it is the withholding agent, intends to withhold 30% from each coupon payment (and expects other withholding agents to do the same), unless the Non-U.S. Holder can avail itself of the benefits of an applicable U.S. tax treaty.[192]

In the case of an issuer that is a foreign corporation, there is generally less risk that coupons paid on an At-Risk Coupon Note would be subject to U.S. withholding taxes, because if such coupons were sourced by analogy to dividends or interest paid by the foreign corporation, they generally would be sourced outside of the United States. Although a full discussion of the relevant issues is outside the scope of this paper, one circumstance in which coupons paid on an At-Risk Coupon Note issued by a foreign corporation *could* potentially be subject to U.S. withholding taxes is if the coupons would be U.S. source under Section 884(f)(1)(A) if they were treated as interest for U.S. federal income tax purposes. Section 884(f)(1)(A) treats certain interest payments by foreign corporations as U.S. source to the extent that the foreign corporation is engaged in a U.S. trade or business and the debt instrument on which the interest is paid has the requisite connection to such a trade or business. If a foreign corporate issuer of an At-Risk Coupon Note has a U.S. trade or business (*e.g.*, a U.S. branch) and the At-Risk Coupon Note is a "U.S. booked liability," as defined in Treas. Reg. § 1.882-5(d), it is possible that coupons paid on the note could be sourced by *analogy* to Section 884(f)(1)(A) interest, which would cause such coupons to be U.S. source income. However, the coupons would not—in fact—be treated as interest for U.S. federal income tax purposes, and thus would not qualify for the portfolio interest exemption.

ii. Are At-Risk Coupon Notes NPCs?

It is worth pausing on whether an At-Risk Coupon Note could be characterized as an NPC. As discussed above,[193] it is difficult to treat Prepaid Derivative Notes with no interim payments as NPCs because they provide only for a single payment at issuance (*i.e.*, the purchase of the note by the holder) and at maturity (*i.e.*, the final settlement payment by the issuer). At-Risk Coupon Notes, however, do not suffer from this infirmity. An NPC is defined 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 upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts."[194] Could an At-Risk Coupon Note satisfy this definition?

There is a difference of opinion on this point among structured note tax practitioners. On the one hand, the NPC regulations provide a rational regime for taxing financial instruments that the IRS believes clearly reflects income. Among their many salutary features, the NPC rules generally provide that payments to a Non-U.S. Holder are foreign source and, thus, generally

[192] Most structured notes tax practitioners believe that, even if At-Risk Coupon Note coupons were subject to withholding, they would likely qualify as "other income" for purposes of most U.S. tax treaties.

[193] *See supra* note 124.

[194] Treas. Reg. § 1.446-3(c)(1)(i).

should not be subject to U.S. withholding tax.[195] Moreover, the NPC regulations contain rules that specifically address NPCs with significant upfront payments—specifically, a swap with one or more "significant" nonperiodic payments is treated for U.S. federal income tax purposes as two separate transactions: (i) an on-market, level payment swap and (ii) a loan.[196] However, the "principal amount" of an At-Risk Coupon Note is not "notional." The coupons are paid with respect to an *actual* principal amount that reflects the holder's investment in the At-Risk Coupon Note, not a "notional" amount. Further, the regulations provide that the "notional principal amount" of an NPC "is any specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract but is not borrowed or loaned between the parties as part of the contract."[197] Although the principal of an At-Risk Coupon Note is not necessarily "borrowed" or "loaned"—because it is at risk and might never be repaid—the definition of "notional principal amount" might suggest that At-Risk Coupon Notes should not be characterized as an NPC for U.S. federal income tax purposes. Accordingly, while some practitioners believe that an At-Risk Coupon Note might be an NPC,[198] others disagree.[199] However, as noted above, the contemporary market practice is to treat At-Risk Coupon Notes as income-bearing prepaid derivative contracts rather than NPCs.

2. Disaggregation & The Strange Case of RevCons

A. Overview

RevCons are a special type of At-Risk Coupon Notes. Perhaps the best place to start discussing the strange case of RevCons is with an illustration. Assume a holder purchases, for $1,000, a five-year note that pays an annual coupon of 7%. At maturity, if the value of the S&P 500 at maturity is greater than or equal to 70% of its value on the pricing date, the holder will receive $1,000; if the value of the S&P 500 at maturity is less than 70% of its value on the pricing date, the holder will lose its principal on a 1-to-1 basis based on the difference between the final value and the initial value of the S&P 500.[200]

Economically, it is reasonably clear that the RevCon in the example above consists of two components: (i) a put option written by the holder to the issuer, pursuant to which the issuer

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[195] *See generally* Treas. Reg. § 1.863-7(b)(1) (providing that "[t]he source of notional principal contract income shall be determined by reference to the residence of the taxpayer as determined under Code Sec. 988(a)(3)(B)(i).").

[196] *See* Treas. Reg. § 1.446-3(g)(4).

[197] Treas. Reg. § 1.446-3(c)(3).

[198] *See* Farber, *supra* note 6, at 681 n.159 (stating that, in the case of an At-Risk Coupon Note, "it is far from clear that Regulation section 1.446-3(c)(3) would be any barrier to the application of that section").

[199] *See* DECS 2010, at 41 n.107 ("A DECS does not constitute . . . a 'notional principal contract.' [because the NPC regulations require], among other things, that the principal of such a contract in fact be "notional." Since an investor makes full payment under the DECS at issuance, and stock is delivered by the issuer at maturity, the 'principal' of a DECS is not 'notional.'").

[200] Some RevCons provide for physical settlement at maturity, while others provide for cash settlement.

purchases downside protection from the holder with respect to the S&P 500 if it declines below 70% of its pricing date value and (ii) a deposit by the holder placed with the issuer to secure the holder's obligation with respect to the put option. The holder's 7% coupon also consists of two components: (i) put option premium payable by the issuer to the holder and (ii) interest payable by the issuer to the holder with respect to the deposit.

The fundamental question is whether it is appropriate to characterize a RevCon for U.S. federal income tax purposes as consisting of those two components or whether it is more appropriate to treat a RevCon as an income-bearing prepaid derivative (like most other At-Risk Coupon Notes).

B. Disaggregation

Much has been written about when a single financial contract may be disaggregated into components for U.S. federal income tax purposes.[201] The general principle that can be distilled from the authorities and commentary is that a financial contract whose components cannot be separated generally is treated as a single instrument for federal income tax purposes, but this principle is not without exceptions. A full discussion of disaggregation is beyond the scope of this paper, but it is worth exploring this area in brief before returning to RevCons.

First, there is authority and guidance suggesting that a financial contract that does not provide for separation of the components cannot be disaggregated for U.S. federal income tax purposes. One key authority in this area is *Chock Full O'Nuts Corp. v. United States*,[202] in which, the Second Circuit did not disaggregate a convertible debt instrument into a non-convertible debt instrument and a call option. The court highlighted the fact that "[i]n no event will the taxpayer be required both to honor the conversion privilege and to redeem the debenture." On the other hand, in the case of a bond-warrant unit, "they are totally independent and separable obligations, and the warrant, unlike the conversion privilege, should be independently valued"[203] Here we see the line of demarcation: severability of the components appears to be the *sine qua non* of disaggregation for U.S. federal income tax purposes.[204] Similarly, in Rev. Rul. 88-31,[205] the IRS disaggregated an investment unit consisting of stock and contingent payment rights because, after a short period of time, the two components could be separately traded. The IRS contrasted the contingent payment rights with "conversion rights on certain instruments, which rights are not separate from the

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[201] In the author's view, the two leading commentaries are JAMES S. PEASLEE & DAVID N. NIRENBERG, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS ch. 16 (5th ed. 2018) and Dickson G. Brown, *Separation Anxiety*, TAX FORUM NO. 582 (2005).

[202] 453 F.2d 300 (2d Cir. 1971).

[203] *Id*., at 305.

[204] *See also Universal Castings Corp. v. Commissioner*, 37 T.C. 107 (1961) (holding that notes held by shareholders that pursuant to a shareholder's agreement, which could be separated from the shares only with the consent of the corporation and other shareholders, were part of a "single investment"); *Hunt Foods & Indus., Inc. v. Commissioner*, 57 T.C. 633 (1972), *aff'd* 496 F.2d 532 (9th Cir. 1974).

[205] 1988-1 C.B. 302.

property that may be converted pursuant to the rights."[206] Finally, in Rev. Rul. 2003-97,[207] the IRS addressed debt/equity forward units with complex terms, concluding that the debt and equity forward components could be treated as separate based on four critical factors: (i) the holder has the unrestricted legal right to (x) convert the unit into a unit consisting of the equity forward and a Treasury "strip" or (y) settle the equity forward and retain the debt (and there was no economic compulsion to prevent the holder from doing so); (ii) if the issuer went bankrupt, the equity forward would terminate but the debt would remain outstanding;[208] (iii) the period that the debt would remain outstanding after a debt remarketing, which would sever debt from the equity forward, was significant; and (iv) it was substantially certain that a remarketing of the debt would succeed.[209] It is clear from the above that separate transferability, alongside the lack of legal or economic compulsion to prevent the holder from severing the units, is generally critical in concluding that the components of a financial instrument can be disaggregated for U.S. federal income tax purposes.

But that's not the end of the story. There are also authorities that support the disaggregation of financial contracts to reflect properly the economic arrangement between the parties even when then components are not severable. In Rev. Rul. 70-108,[210] the IRS ruled that convertible preferred stock carrying a right to purchase additional common stock in the future was not consideration that could be treated as "solely voting stock" for purposes of an Code Sec. 368(a)(1)(B) reorganization; in effect, the IRS disaggregated the preferred stock from the stock purchase rights and concluded that the latter busted the "B" reorganization. In *Farley Realty Corporation v. Commissioner*,[211] the court held that a single mortgage contract (which provided for a repayment of principal and a right to share in the appreciation of the property) consisted of debt and equity components, and disaggregated a single settlement payment into settlement of the claimant's rights as a creditor and as an equityholder, respectively. In 1984, in GCM 39144, the IRS recognized *Farley Realty* as authority for disaggregating a financial contract that includes a debt component and a right to receive a contingent amount, even when they are not explicitly severable. Similarly, in *Richmond, Fredericksburg and Potomac Railroad Co. v. Commissioner*,[212] the Tax Court disaggregated stock that paid a guaranteed fixed dividend and an "excess dividend," treating the guaranteed component as debt for U.S. federal income tax purposes, because the excess component essentially constituted equity for U.S. federal income tax purposes. In *Duval Sulphur & Potash Co. v. Phinney*,[213] the court permitted a deduction for "interest" paid with respect to an agreement to subscribe for stock

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[206] *Id*.

[207] 2003-2 C.B. 380.

[208] On the issue date, the issuer reasonably believed, based on advice from counsel, that this arrangement would be enforceable in bankruptcy.

[209] In reality, many of the remarketings failed. *See* GARLOCK, *supra* note 32, at ¶ 907.02.

[210] 1970-1 C.B. 78 (1970).

[211] 279 F.2d 701 (2d Cir. 1960).

[212] 62 T.C. 174 (1974), aff'd, 528 F.2d 917 (4th Cir. 1975).

[213] 51 A.F.T.R. 1416 (W.D. Tex. 1956).

because the relevant agreement "created a debtor-creditor relationship." Moreover, as noted above, the DECS FSAs explicitly considered "bifurcation" of the DECS into components as a viable potential characterization.[214] On the other hand, the DECS FSAs did not treat any amount payable with respect to the DECS as interest, which suggests that the IRS implicitly rejected a disaggregation approach.[215] The three-volume 2,700 page IRS report on Enron's tax planning transactions noted the following with respect to Enron's DECS, citing *Farley Realty* and *Richmond, Fredericksburg*:

> The investment unit characterization, although it perhaps most clearly reflects the underlying economics of the transaction and is the characterization that generally has been settled on by taxpayers, suffers from a general lack of authority for bifurcating a single financial instrument into its constituent components for tax purposes.[216]

Finally, there are several instances in which either the Code or the Treasury regulations expressly disaggregate a single financial contract to achieve a clear reflection of the underlying economics.[217] For example, Treas. Reg. § 1.446-3(g)(4) treats a "significant nonperiodic payment" with respect to an NPC as an embedded loan for U.S. federal income tax purposes. Treas. Reg. § 1.988-2(e) disaggregates "currency swaps" into hypothetical loans in different currencies. For purposes of testing when a holder of stock has a "position" in "substantially similar or related property," Treas. Reg. § 1.246-5(b)(3) defines a "position" as an "interest . . . in property or any contractual right to a payment, whether or not severable from stock or other property." Similarly, Treas. Reg. § 1.263(g)-4(c), Example 3 and Treas. Reg. § 1.1092(d)-1(d) treat contingent interest on a debt instrument as a separate position in property for purposes of the straddle rules. Treas. Reg. § 1.467-4 effectively disaggregates certain rental agreements into a level rental agreement and an embedded loan. The original CPDI regulations, proposed in 1991, would have "bifurcated" CPDIs into contingent and noncontingent components. In Rev. Rul. 2002-30,[218] the IRS disaggregated contingent and noncontingent payments made pursuant to a single NPC into "two independent components" to achieve a clear reflection of income.[219]

In sum, although the weight of authority indicates that the tax law generally permits disaggregating a single financial instrument into components only when the components are severable, there is authority for disaggregation even in the absence of severability. Moreover, the

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[214] *See supra* note 169 and accompanying text.

[215] *See, e.g.*, FSA 200131015 ("As developed previously, the Instruments should not be characterized as debt. Consequently, the quarterly payments cannot be characterized as interest.").

[216] STAFF OF THE J. COMM. ON TAX'N, REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS, at 341 (Comm. Print 2003).

[217] For even more examples, see PEASLEE & NIRENBERG *supra* note 201, at ch. 16.F.

[218] 2002-1 C.B. 971.

[219] It is also interesting to note that Treas. Reg. § 1.1275-6 also ignores severability in attempting to achieve a clear reflecting of economics. Treas. Reg. § 1.1275-6 achieving the inverse result of the authorities cited in the paragraph above—it aggregates severable components into a single financial instrument for U.S. federal income tax purposes—by allowing a holder or issuer to "integrate" a debt instrument and a hedge if certain criteria are satisfied.

IRS and Treasury have in many cases promulgated rules that explicitly disaggregate financial instruments to reflect properly the underlying economics of the instrument. However, it is important to keep in mind that disaggregation may prove challenging in any given case, because it is often possible to disaggregate a single financial contract in several possible ways.[220] The disaggregation approach is most compelling when it is clear that a particular disaggregation approach is the most economically compelling.

C. Market Practice

Despite the fact that the weight of authority suggests that two components must be severable before a taxpayer is permitted to disaggregate a single financial instrument, the current market practice is to disaggregate a RevCon consistent with its economics—*i.e.*, to treat it for all U.S. federal income tax purposes as a unit consisting of (i) a put option written by the holder to the issuer with respect to the Reference Asset and (ii) a deposit placed by the holder with the issuer to secure the holder's obligation under the put option.[221] Almost invariably, the holders and the issuer will agree to treat the RevCon in this fashion which structured note tax practitioners believe strengthens the characterization.[222] As a result, the market treatment of RevCons is distinguishable from other At-Risk Coupon Notes. Why is this the case? Part of the answer lies in historical path dependency—the market and tax advisors simply got comfortable with this approach at an early stage and this has become the accepted treatment. The more satisfying answer is that the economic case for disaggregating RevCons in this manner is very compelling—RevCons very clearly reflect the economics of a put option and a deposit. Other At-Risk Coupon Notes, which may have the potential for upside participation, contingent coupons, or multiple embedded options (or option spreads), are harder to disaggregate cleanly into separate components, and there are often competing disaggregation approaches (none of which may appear to be more clearly correct than the other). Moreover, some advisors believe that the authorities discussed above may support "bifurcation" (*i.e.*, disaggregation into two separate components) but not "trifurcation" (*i.e.*, disaggregation into three components). Since disaggregating a RevCon into a put option and a deposit is economically compelling and does not require "trifurcation," most structured note tax

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[220] *See* Am. Bar Ass'n, *Comments Concerning Notice 2008-2*, at 11 n.15 (Nov. 18, 2002) ("This discussion illustrates one of the principal reasons bifurcation has not generally been adopted in the area of financial products taxation: there are often many ways to bifurcate a single financial instrument, none of which can definitively be said to be the most economically correct way.").

[221] *See* GARLOCK, *supra* note 32, at ¶ 907[C] ("The problems with [treating RevCons either as debt instruments or as income-bearing prepaid derivative contracts] have led many issuers to treat mandatory and reverse exchangeables for tax purposes as what they unquestionably are economically (but not legally): a combination of a forward contract or option with respect to the reference stock and a debt instrument (sometimes referred to as a 'deposit') by the investor with the issuer to secure the investor's obligation under the forward contract or option."); Kunkel *supra* note 6, at 17 ("A review of several prospectuses for publicly offered reverse convertibles reveals that the issuers of these securities may take the position (and, if so, that holders may be required to agree to take the same position) that the reverse convertibles consist of two distinct instruments for tax purposes: the sale of a put option by the holder to the issuer, and a deposit of cash by the holder with the issuer that serves as collateral to secure the holder's obligation under the put option."); Farber *supra* note 6, at 642 ("Reverse exchangeables are commonly treated by issuers and holders as a combination of a deposit accruing interest at a specified yield . . . plus a put option written by the holder to the issuer with respect to the Reference Assets, for which the holder receives from the issuer a periodic premium . . . .").

[222] *See, e.g.*, *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967) (providing that taxpayers generally may not disavow the form of the transaction they selected unless there exists fraud, duress, undue influence, or the like).

practitioners believe that there is at least a "reasonable basis" for the disaggregated treatment of RevCons. Finally, several commentators have pointed out that treating a RevCon as a CPDI is unlikely to result in tax treatment of the coupon that is materially different from the bifurcated approach prevalent in the market.[223]

i. U.S. Holders

Because RevCons are disaggregated into a put option and a deposit, issuers generally allocate the coupon between the two components, explicitly designating a portion as put premium and a portion as interest income, each payable by the issuer to the holder.

U.S. Holders include interest payments in respect of the debt component in income in accordance with their regular method of accounting for interest for U.S. federal income tax purposes. Put option premium payments in respect of the put option component generally are not be taxed until a sale, exchange, or retirement of the RevCon. At maturity, such payments are taxed as a short-term capital gain.[224]

The tax treatment of U.S. Holders on disposition is more complex. Upon a sale, exchange, or retirement of the RevCon, the U.S. Holder generally should allocate the cash received between the debt component and the put option component on the basis of their respective values on the date of such taxable disposition. The U.S. Holder should generally recognize gain or loss with respect to the debt component in an amount equal to the difference between the amount of the proceeds allocable to the debt component (less accrued and unpaid interest which will be taxable as such)[225] and their adjusted tax basis in the debt component. This gain or loss should be capital gain or loss and should be long-term capital gain or loss if the U.S. Holder is treated as having held the debt component for more than one year at the time of such taxable disposition. If the put option component has a positive value on the date of such taxable disposition, the U.S. Holder should generally recognize short-term capital gain equal to the portion of the proceeds allocable to the put option component plus any previously received put option premium.[226] If the put option component has a negative value on the date of such taxable disposition, the U.S. Holder should generally be treated as having paid the buyer (or the issuer, in a retirement) an amount equal to the negative value in order to assume the U.S. Holder's rights and obligations under the put option

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[223] *See* Kunkel, *supra* note 6, at 18 ("[T]he projected amount payable at maturity should be less than the face amount of the reverse convertible, and some portion of each noncontingent periodic payment will represent a return of principal. As a result, the treatment of the coupon payments under the CPDI rules would be similar to the agreed-upon treatment of these payments as part interest and part option premium."); Farber, *supra* note 6, at 679 ("The result would be, like the chosen characterization, that the holders would not be required to include any amounts of Coupon in excess of the issuer's comparable yield . . . ."). However, even though the holders' inclusions may not differ significantly, treating a RevCon as a CPDI (as opposed to a bifurcated instrument) would have other U.S. federal income tax consequences. For example, the CPDI regulations would implicate the positive and negative adjustment rules, as well as the CPDI character rules, which treat gain or loss recognized with respect to a CPDI as ordinary in most cases.

[224] *See* Code Sec. 1234(b).

[225] *See* Treas. Reg. § 1.61-7(d).

[226] *See* Code Sec. 1234(b).

component. In that case, the U.S. Holder should recognize a short-term capital gain or loss in an amount equal to the difference between the total put option premium previously received and the amount of the payment deemed made by the U.S. Holder with respect to the buyer's (or issuer's) assumption of the put option component. The amount of the deemed payment will be added to the price allocated to the debt component in determining the gain or loss in respect of the debt component.[227]

For example, assume a U.S. Holder purchased a RevCon for $1,000. The RevCon pays a 9% coupon (which the issuer allocates between interest and put premium) and pays at maturity (i) $1,000 if the Reference Asset value around the maturity date is greater than or equal to 80% of its initial value or (ii) $1,000 reduced by the percentage decline in the Reference Asset from issuance to maturity if the Reference Asset value around the maturity date is less than 80% of its initial value. Assume that the Reference Asset has declined by 30% and the U.S. Holder receives $700 at maturity. First, the U.S. Holder is deemed to make a payment equal to the negative value of the option (negative $300) and has a short-term capital loss to that extent.[228] Next, the deemed $300 payment is added to the amount of purchase price allocated to the debt component. In other words, the $300 is added to the $700 received. In total, the U.S. Holder is deemed to receive $1,000 in redemption of the debt component and will recognize no gain or loss with respect to the debt component, which has a tax basis of $1,000.

ii. Non-U.S. Holders

The current market view is that amounts paid with respect to a RevCon to Non-U.S. Holders generally should not be subject to U.S. withholding taxes.

Under the characterization agreed by the issuer and the holder, Non-U.S. Holders generally receive interest with respect to the debt component free of U.S. withholding taxes because they qualify for the portfolio interest exemption. Non-U.S. Holders also should not be subject to withholding tax with respect to the put premium or any other amounts received in respect of the put option component both because such amounts do not constitute FDAP[229] and because such proceeds should be non-U.S. source income.[230]

Nevertheless, since there is somewhat limited support for the disaggregation approach, structured note tax practitioners generally consider the withholding tax analysis that would apply if the IRS rejected the characterization adopted by the parties. Here, the analysis is identical to the withholding tax analysis for other At-Risk Coupon Notes discussed in Part II.c.iii.1.B.i(2) *supra*. However, it is easier to reach the conclusion that coupons payable with respect to a RevCon should not be subject to U.S. withholding taxes than in the case of other At-Risk Coupon Notes: in the case of a RevCon, this analysis is bolstered by the express agreement of the parties to adopt the

[227] Some issuers and structured note tax practitioners simply disclose that the put option is deemed to be cash settled upon retirement, with identical results to the description above.

[228] *See id.*

[229] *See* Treas. Reg. § 1.1441-2(b)(2)(i).

[230] *See* Code Sec. 865(a).

disaggregation approach. Accordingly, almost all structured note tax practitioners are comfortable that amounts paid with respect to a RevCon to Non-U.S. Holders generally should not be subject to U.S. withholding taxes.

3. The Stranger Case of CLNs

Like RevCons, to which they bear some resemblance, CLNs are a special type of At-Risk Coupon Note and present several interesting tax issues.[231] Some CLNs exist outside of "traditional" structured note distribution channels—*e.g.*, CLNs are prevalent in securitization structures—and the structure of CLNs varies widely (*e.g.*, acceleration upon default, linkage to a pool of credits, reference obligations *owned* by the issuer other than as hedges, etc.). This discussion, however, is focused on providing only a brief summary of the issues presented by CLNs that are issued as structured notes.

Assume a holder purchases, for $1,000, a five-year note that pays an annual coupon of 7%. The CLN is linked to a reference obligation (*e.g.*, a bond issued by a publicly-traded company). At maturity, if the reference obligation did not default, the holder will receive $1,000. If the reference obligation *did* default, the investor will receive at maturity $1,000 minus some amount (often, a percentage reduction equal to the decline in the trading value of the reference obligation).[232]

A. CLNs as Disaggregated Instruments

CLNs bear a striking resemblance to RevCons: the CLN consists economically of a derivative—*i.e.*, either a put option or a credit default swap ("CDS")—stapled to a deposit. Accordingly, some issuers and structured note tax practitioners adopt a disaggregation approach with respect to CLNs that is similar to the disaggregation approach the market adopts for RevCons. Just as with RevCons, the disaggregation is relatively tidy: the most compelling disaggregation of a CLN is into a deposit and a derivative (either an option or a CDS).

If the CLN is disaggregated into a deposit and a put option, the U.S. federal income tax treatment of U.S. and Non-U.S. Holders of the CLN generally should be identical to the treatment of holders a RevCon.[233]

If, instead, the CLN is disaggregated into a deposit and a CDS, the analysis is slightly more complicated. The U.S. federal income tax treatment of CDSs is not entirely clear.[234] However,

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[231] For more on CLNs, see David Z. Nirenberg & Steven L. Kopp, *Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. TAX'N 82 (1997); Bruce Kayle, *Will the Real Lender Please Stand Up? The Federal Income Tax Treatment of Credit Derivative Transactions*, 50 TAX LAW. 569 (1997); Farber, *supra* note 6, at 643–44.

[232] Often, when the reference obligation defaults, the CLN is "accelerated" and is retired before its maturity date.

[233] *See supra* Part II.c.iii.2.

[234] *See, e.g.*, Notice 2004-52, 2004-32 I.R.B. 168 (Aug. 9, 2004) (analogizing CDSs, in the alternative, to options, guarantees, insurance, and NPCs); N.Y. State Bar Ass'n, *Report on Credit Default Swaps*, (Sept. 9, 2005) (recommending that CDSs be subject to the timing rules applicable to NPCs, with some modifications).

Treasury Regulations proposed in 2011 would treat CDSs as NPCs, and the market generally follows this approach.[235] Accordingly, this approach to a CLN would treat it as a unit consisting of a deposit and an NPC (although, again, the U.S. federal income tax characterization of CDSs is not free from doubt). The issuer and holder would generally follow the same approach as for RevCons and treat a portion of the coupon as deposit interest and treat the remaining portion as attributable to the NPC. The NPC would be accounted for under the rules of Treas. Reg. § 1.446-3. A full discussion of the NPC regulations is outside the scope of this paper, but suffice to say that, generally speaking, the NPC embedded into a CLN would give rise to periodic payments from the issuer to the holder.[236] In each taxable year, a U.S. Holder would (i) accrue deposit interest income in accordance with its usual method of account for U.S. federal income tax purposes and (ii) recognize the daily ratable portion of each periodic payment that relates to that year *regardless of its method of tax accounting*.[237] Upon a sale or exchange of the CLN, amounts received by the U.S. Holder attributable to the NPC would generally give rise to capital gain or loss.[238] Upon an *early* retirement of the CLN (*e.g.*, upon default or pursuant to an issuer call), although the matter is not free from doubt, it is possible that amounts received by U.S. Holder attributable to the NPC would be treated as a "termination payment," which should give rise to capital gain or loss.[239] Upon a *scheduled* retirement of the CLN, however, it is possible that amounts received by the U.S. Holder attributable to the NPC would be treated as a final *nonperiodic* payment, which should give rise to ordinary income.[240] Non-U.S. Holders generally should not be subject to U.S. withholding tax with respect to the coupons on a CLN consisting of a deposit and NPC, because the deposit interest should qualify for the portfolio interest exemption and the NPC payments would be foreign source.[241]

Which approach is more correct: treating the non-deposit component of the CLN as a put option or as an NPC? The two approaches clearly produce different results for U.S. Holders.[242] If

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[235] *See* Prop. Reg. § 1.446-3(c)(1)(iii).

[236] *See* Treas. Reg. § 1.446-3(e)(1) (generally defining "periodic payments" as "payments made or received pursuant to a notional principal contract that are payable at intervals of one year or less during the entire term of the contract . . . that are based on a specified index . . ., and that are based on . . . a single notional principal amount . . . .").

[237] *See* Treas. Reg. § 1.446-3(e)(1)

[238] The NPC is assumed to be a capital asset in the hands of the U.S. Holder, and the "sale or exchange" requirement is satisfied here. *See generally* Code Sec. 1222.

[239] *See* Treas. Reg. § 1.446-3(h)(1) (defining a "termination payment" as "[a] payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract is a termination payment to the party making the termination payment and the party receiving the payment."); Code Sec. 1234A; Prop. Reg. § 1.1234A-1.

[240] *See* Prop. Reg. § 1.1234A-1(b) ("[S]ection 1234A does not apply to . . . any final scheduled payment. If a payment made or received pursuant to a notional principal contract is not a termination payment as defined in Treas. Reg. § 1.446-3(h)(1), the payment constitutes ordinary income or expense."). Note that a final nonperiodic payment would be a miscellaneous itemized deduction and, thus, would be nondeductible to an individual U.S. Holder.

[241] *See* Code Sec. 871(h)(1); Treas. Reg. § 1.863-7.

[242] Tax consequences for Non-U.S. Holders should, generally, be identical under either approach—*i.e.*, no U.S. withholding taxes with respect to the CLN.

any answer can be found, it likely lies in the terms of the CLN. Although neither the Code nor the Treasury regulations define a "CDS," if the CLN has provisions comparable to market-standard commercial CDSs (*e.g.*, the use of ISDA methodology to determine when a credit event has occurred; acceleration upon the occurrence of such an event; etc.), the NPC approach is compelling. By contrast, if the CLN has the hallmarks of a traditional put option (*e.g.*, no acceleration upon an event of default; valuation of the reference obligation not computed by ISDA methodology; etc.), the put option approach can make some sense.

B. CLNs as Debt Notes

Alternatively, some structured note tax practitioners believe that at least certain CLNs are properly characterized as Debt Notes. There are two theories to overcome the challenge that a CLN does not embody an unconditional promise to pay a sum certain.

First, some structured note tax practitioners believe that, when the principal amount of the CLN is contingent because it is based on the performance of a debt instrument, the contingency is insufficient to cause it to be treated as non-debt for U.S. federal income tax purposes. Generally speaking, the issuer of the CLN will be more creditworthy than the issuer of the reference obligation. Since the underlying reference obligation is generally a debt instrument for U.S. federal income tax purposes, these advisors believe that it is reasonable to treat a CLN as a Debt Note.[243] However, in the author's experience, this is not the most common approach.

Second, some structured note tax practitioners are comfortable treating only certain CLNs as Debt Notes—namely, CLNs where the probability of default is sufficiently remote. There are multiple approaches to measuring remoteness. Some practitioners establish a numerical standard based on the probability of a default of the reference obligation. For example, if there is only a 3% probability that the reference obligation will default during the term of the CLN, some practitioners feel comfortable treating the CLN as a Debt Note.[244] Alternatively, some practitioners feel comfortable treating a CLN as a Debt Note if the underlying reference obligation is rated "investment grade" or higher.[245] Others apply a similar approach by treating a CLN as a Debt Note only if the "credit spread" of the reference obligation is comparable with those of "investment grade" debt instruments.

If the issuer and holder treat the CLN as a Debt Note, the next question is whether the CLN should be treated as a CPDI. Under the CPDI regulations, a payment is not a contingent payment merely because of a contingency that, as of the issue date, is either "remote" or incidental.[246] The Treasury Regulations provide that a contingency is remote "if there is a remote likelihood either

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[243] Note that this approach might be less compelling for CLNs that are not linked to a specific reference obligation but are instead linked to the credit of a specific *reference entity*.

[244] This is similar to the approach practitioners adopt in testing "remoteness" for purposes of the CPDI regulations. *See infra* note 249 and accompanying text.

[245] *Cf.* Jason Schwartz & David S. Miller, *Collateralized Loan Obligations*, 6585-1ST TAX MGMT. PORT. (BNA), at II.A.1 (2024); ("It is typical for a CLO's deal counsel to opine that the secured notes that receive investment grade credit ratings 'will' be debt for U.S. tax purposes.")

[246] *See* Treas. Reg. § 1.1275-4(a)(5).

that the contingency will occur or that the contingency will not occur."[247] If the likelihood of occurrence is remote, then it is assumed that the contingency will not occur.[248] There is no authority on the definition of "remote"; however, the market convention for debt instruments is that a contingency will be treated as remote if the chance that it occurs is less than 5%.[249] The question here is whether a default on the reference obligation, which would impair the principal of the CLN, is "remote." Since the issuer is treating the CLN as a Debt Note in the first instance only because reference obligation default is remote (under any of the approaches discussed in the preceding paragraph), it makes sense to treat that contingency as remote for purposes of the CPDI rules as well. Accordingly, unless the CLN has other contingencies or the issuer treated the CLN as a Debt Note simply because it is linked to underlying debt (without analyzing the probability of default), it is likely that a CLN treated as a Debt Note would be a non-CPDI.

III. INTERESTING STRUCTURED NOTE ISSUES

This Part III will discuss some interesting tax issues that arise once an issuer and its tax advisor have successfully arrived at the proper characterization of a structured note.

a. Plain Vanilla Debt Issues

This Part III.a discusses some issues presented by structured notes that are treated as plain vanilla debt.

i. Step-Up Notes

One interesting example of a structured note treated as plain vanilla debt is a "step-up note." Assume a holder purchases, for $1,000, a five-year note that pays (on a quarterly basis) 5% annual interest in the first two years, 6% in the next two years, and 7% in the final year. The issuer has a right to call the note for the par amount plus accrued and unpaid interest on each of the quarterly interest payment dates. Somewhat surprisingly, this note likely bears no OID, even though—in the absence of a special rule—the QSI amount would be only 5% and the note pays higher amounts of interest in later years. The key is Treas. Reg. § 1.1272-1(c)(5), which provides that "an issuer is deemed to exercise or not exercise an option or combination of options in a manner that minimizes the yield on the debt instrument." Because the issuer would minimize the yield if it exercised the call option immediately before the first step-up date, the issuer is conclusively presumed to exercise the option (regardless of whether it actually intends to do so). If the issuer does not, in fact, exercise the call, solely for purposes of Code Secs. 1272 and 1273 (but not for purposes of gain or loss recognition by either the issuer or the holder), the note is

[247] *See* Treas. Reg. § 1.1272-5(h)(2).

[248] *See id.*

[249] *See* Jeff Maddrey, *Time Value of Money—Holders of Debt Instruments*, 181-1ST TAX MGMT. PORT. (BNA), at II*.E.*1 (2024) ("Remote for this purpose is not defined but many assume it is a low probability (5% or less)."); Michael E. Bauer, Y. Bora Bozkurt, & Daniel R.B. Nicholas, *A Tax Perspective on Certain Contingent Interest Provisions in Modern Credit Agreements*, 21 J. TAX'N FIN. PRODS. NO. 2, at 5, 9 (2024) ("No guidance exists with respect to what "remote" (generally considered to be less than 5%) . . . ."); Eli Dubin, *The Tax Treatment of Interest Rate Stepdowns*, 21 J. TAX'N FIN. PRODS. NO. 1, at 5, 9 (2024) ("The general market convention is that a contingency will be treated as remote if the chance that it occurs is less than five percent.").

deemed reissued for an amount equal to its adjusted issue price.[250] If the note was issued with no OID or with *de minimis* OID for an issue price equal to the par amount, the resulting reissued note generally should also be plain vanilla debt with no OID.[251] This would be the case with respect to each step-up date.

However, issuers of a note with this type of structure—and their advisors—should take heed of Treas. Reg. § 1.1275-2(g)(3), Example 1. In the example, a taxpayer issues a current-pay, increasing-rate note that provides for an early call option. The example concludes that, under the OID anti-abuse rule in Treas. Reg. § 1.1275-2(g), the application of Treas. Reg. § 1.1272-1(c)(5) produces an unreasonable result, and thus the IRS Commissioner can apply the OID regulations without regard to the option rule in Treas. Reg. § 1.1272-1(c)(5). Critically, the example includes two key statements: (1) the issuer is not expected to exercise the option and (2) "a principal purpose of including the option in the terms of the note is to limit the amount of interest income includible by the holder in the period prior to the call date by virtue of the option rules in Treas. Reg. § 1.1272-1(c)(5)." Unlike Example 1, in practice, issuers of structured notes generally include a call option to protect themselves from the potential of paying interest on a step-up note that is in excess of the prevailing market interest rate.

ii. Digital Contingent Notes

Occasionally, a Debt Note with contingencies (which would otherwise cause it to be treated as a CPDI) is treated as plain vanilla debt. For example, assume a holder purchases, for $1,000, a five-year note that pays a digital return at maturity. As noted above, a digital return is a payout profile that ensures the holder will receive *one of two* pre-determined payoffs, depending on the performance of the Reference Asset. The Debt Note will pay at maturity either (i) $1,000 or (ii) if the percentage increase in the S&P 500 index (if any) from the issue date to the maturity date is more than 10%, $1,400. Because the note is 100% principal-protected, it should be a Debt Note. At first glance, one might be tempted to conclude that this note should be treated as a CPDI for U.S. federal income tax purposes, because it provides for a contingent payment.[252] However, in this case, the issuer's financial models lead it to conclude that the probability of holders receiving the $1,400 payment is 90%. The OID regulations set forth the "significantly more likely than not" ("SMLTN") rule, which provides as follows: "If, based on all the facts and circumstances as of the issue date, a single payment schedule for a debt instrument, including the stated payment schedule, is significantly more likely than not to occur, the yield and maturity of the debt instrument are computed based on this payment schedule."[253] A note subject to the SMLTN rule is exempt from the CPDI rules.[254] Because the note provides for a finite number

[250] Treas. Reg. § 1.1272-1(c)(6).

[251] *See* Code Secs. 1273(b)(4) & 1274 (resulting in new debt instrument issued in a debt-for-debt exchange having an issue price equal to its stated principal amount if it has adequate stated interest).

[252] *See* Treas. Reg. § 1.1275-4(a)(1).

[253] Treas. Reg. § 1.1272-1(c)(2).

[254] *See* Treas. Reg. § 1.1275-4(a)(2)(iii).

of payment schedules[255] and one payment schedule (the one that pays $1,400 at maturity) should be viewed as "significantly more likely than not" to occur, the note should be a plain vanilla debt instrument that bears $400 of OID.[256]

The example above assumes that 90% is "significantly more likely than not." But what does "significantly more likely than not" mean in the case of lower probabilities? Garlock says the following: "No guidance is provided as to the meaning of [the phrase] but the ordinary meaning of the words would suggest that a probability of two-thirds or higher would satisfy this test."[257] Some structured note tax practitioners generally draw the line at 75% and conclude that a result with a probability at least this high "should" be "significantly more likely than not." Others may take a more conservative approach: in borderline cases (a probability of 60-70%), they generally adopt the treatment that results in holders accruing the maximum amount of interest income. Let's modify the example above and add some facts. Assume that the probability of the holder receiving the $1,400 payment is 65%, which produces a yield to maturity (compounded semi-annually) of 3.41%, and that the issuer's "comparable yield" (compounded semi-annually) for purposes of the CPDI rules is 2.38%.[258] This raises a serious dilemma. Should the issuer take the position that 65% is *not* "significantly more likely than not" and treat the Debt Note as a CPDI with a comparable yield of 2.38%? Alternatively, should the issuer instead take the position that the SMLTN rule applies, and treat the Debt Note as a non-CPDI OID debt instrument with a yield to maturity of 3.41%? In the absence of guidance on the definition of "significantly more likely than not," it may be wise to adopt the most conservative approach.[259] However, it is not simple to determine which approach is more conservative. On the one hand, treating the Debt Note as a non-CPDI OID debt instrument clearly would cause the holder to accrue more OID over the term of the Debt Note, since the yield on the non-CPDI OID debt instrument (3.41%) is higher than the issuer' s comparable yield (2.38%). Moreover, treating the Debt Note as a non-CPDI would cause the holder to recognize a $400 capital loss at maturity if the holder received $1,000 at maturity instead of the $1,400 projected on the SMLTN payment schedule. Thus, non-CPDI treatment would seem to be the more conservative characterization of the Debt Note—*i.e.*, the characterization more adverse to the holder and thus less likely to elicit challenge from the IRS. On the other hand, CPDI treatment is also, in some sense, conservative, because gain from the sale or exchange of a CPDI is treated as ordinary income, not capital gain. Moreover, as with any debt instrument, the holder's inclusions are generally the mirror image of the issuer's deductions: Treating the Debt Note as a CPDI would reduce the issuer's interest deductions relative to treating the Debt Note as a non-CPDI OID debt instrument. Nevertheless, in such a case, many structured notes tax practitioners

[255] The only possible payments under the terms of this note are $1,000 or $1,400, in each case payable at maturity.

[256] *See* Treas. Reg. § 1.1272-1(c)(3).

[257] GARLOCK, *supra* note 32, at ¶ 510.01.

[258] For a summary of the CPDI rules, see *infra* Part II.b.ii.2.C.

[259] Some structured notes tax practitioners take the view that the CPDI regulations cast a wide net, create a workable and rational set of rules, and are generally viewed as taxpayer-unfriendly rules. As a result, when confronting Debt Notes with digital payouts, these practitioners take the view that the CPDI regulations generally should apply in the absence of a *very* high probability of the holder receiving one of the digital payouts.

likely would conclude that applying the SMLTN rule and causing the holder to accrue more OID over the term of the Debt Note is indeed the more conservative approach.

A similar difficulty would arise if the Debt Note in the example above had a relatively high probability of repaying only the par amount (meaning *no* OID would be accrued under the more likely payment schedule). In such a case, one must contend with the possibility that the SMLTN rule could treat the holder as being required to accrue *no income* until the instrument matures. In such cases, CPDI treatment would clearly be more conservative (at least from the holder's perspective), so perhaps this is a less troubling dilemma than the one discussed in the prior paragraph.

b. VRDI & CPDI Issues

This Part III.b is a "tasting menu" of some interesting issues presented by structured notes treated as VRDIs and CPDIs.

i. Frontloading & Backloading

1. The Problem

Under the VRDI regulations, a variable rate of interest is not an objective rate if it is "reasonably expected" that the average value of the rate during the first half of the instrument's term will be either significantly less than (*i.e.*, the interest is "backloaded") or significantly greater than (*i.e.*, the interest is "frontloaded") the average value of the rate during the final half of the instrument's term.[260] Given the lack of guidance on what it means for interest to be frontloaded or backloaded—*i.e.*, what it means for interest during one half to be "significantly" less than or greater than interest during the other half—it is often challenging to apply this rule to structured notes. Recall that if a Debt Note with contingent interest does not qualify as a VRDI and certain exceptions do not apply, the Debt Note will be treated as a CPDI.[261]

An example in the regulations (the "S&P Example") makes the application of this rule to equity indices particularly challenging.[262] In the example, on January 1, 1997, the taxpayer issued a debt instrument that provided for annual interest payments at the end of each year based on a fixed percentage of the value of the S&P 500 Index. Because variations in the value of the S&P 500 cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds, it is not a qualified floating rate. However, it potentially *could* be an objective rate because it is determined using a single fixed formula and based on objective financial or economic information.[263] Nevertheless, the example concludes that it is not an objective rate because "based on historical data, it is reasonably expected that the average value of the rate during

[260] *See* Treas. Reg. § 1.1275-5(c)(4).

[261] *See* Treas. Reg. § 1.1275-5(a)(1).

[262] *See* Treas. Reg. § 1.1275-5(d), Example 5.

[263] *See* Treas. Reg. § 1.1275-5(c)(3).

the first half of the instrument's term will be significantly less than the average value of the rate during the final half of the instrument's term."[264]

2. Market Practice

There is no market consensus among structured note practitioners about how to apply the frontloading/backloading rules in Treas. Reg. § 1.1275-5(c)(4). Note that the test is based on whether frontloading or backloading is "reasonably expected." Accordingly, some advisors simply ask the issuer whether there is any factor, based on the index, that would make the issuer believe that there is significant frontloading or backloading.

Some advisors look to the Treas. Reg. § 1.1001-3 by analogy to define what constitutes "significant" frontloading or backloading. Specifically, under those rules, a change in the yield of a debt instrument by the greater of (i) 25 basis points or (ii) 5% of the annual yield of the original instrument constitutes a significant modification and gives rise to a taxable event.[265] By analogy to that rule, some advisors are comfortable that a reasonably expected difference of less than 25 basis points between the first-half and second-half averages is not "significant."[266]

Other advisors take a more flexible approach, perhaps on the theory that Treas. Reg. § 1.1275-5(c)(4) is an anti-abuse rule, intended to prevent taxpayers from gaming the VRDI rules by inappropriately accelerating the issuer's interest deductions or deferring the holder's interest income. Some apply the test described in the prior paragraph using a "tiered" approach. These advisors feel very comfortable that a Debt Note does not violate Treas. Reg. § 1.1275-5(c)(4) if it complies with the 25 basis points/5% of annual yield test above. But they also get comfortable with VRDI treatment even if the difference is higher. For example, they reach a lower (but still respectable) level of comfort if the absolute value of the difference between the average annual yield of one half is a larger percentage but still less than 10%.[267] So on and so forth for higher percentages. A variation of this approach is to compare the difference between the first- and second-half averages to the projected average value of the rate over the *entire term* of the note.

Some advisors compare the difference between the averages to what the difference would be if the note were linked to a commonly-used qualified floating rate (such as SOFR). For example, if the difference between the average rate of interest in the first half is 15% lower than the average rate of interest of the second half, but the average rate of interest of the second half of a note linked to SOFR would also be 15%, advisors may still conclude that the note is a VRDI. After all, the benchmark qualified floating rate will generally be the "gold standard" of a valid rate for a VRDI, and thus this seems like a reasonable approach.

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[264] Treas. Reg. § 1.1275-5(d), Example 5.

[265] *See* Treas. Reg. § 1.1001-3(e)(2).

[266] *See, e.g.*, Marian, *supra* note 6, at 331.

[267] 10% is a "magic number" that has significant relevance in the land of structured notes. Its provenance is perhaps based on the rule in the tax-exempt arbitrage bond regulations that states that 10% is a "substantial amount." *See* Treas. Reg. § 1.148-1(f)(4)(ii).

Whichever approach is used, the S&P Example also creates significant uncertainty. Some advisors believe that the S&P Example stands for the proposition that the S&P 500 specifically is *per se* backloaded, and a note with interest linked to the S&P 500 that otherwise qualifies as a VRDI (*e.g.*, the interest is paid or compounded at least annually and the principal is noncontingent) must be a CPDI. Some read the S&P Example more broadly to conclude that it taints all equity Reference Assets.

Others, by contrast, take a more measured approach and confine the S&P Example to its particular facts. There are two theories for this approach. First, the S&P Example could be viewed simply as an attempt by the IRS and Treasury to illustrate backloading—it is simply meant to be illustrative and does not imply that equity-linked Debt Notes should be categorically excluded from the VRDI rules. Second, and relatedly, some argue that the better reading of the S&P Example is that it *posits* that backloading exists "based on historical data," without implying whether or not this is true in the real world. In this regard, Marian and Moin say the following: "It is our understanding that notwithstanding the example, in analyzing debt instruments, practitioners take the view that the S&P 500 and other equity indices are not expected, by definition, to increase under all circumstances or over all time periods."[268]

ii. Pricing Date vs. Issuance Date

1. The Problem

In several contexts under the OID regulations, it is not entirely clear whether to look to the pricing date or the issue date.[269] For example, when the issuer determines the projected payment schedule and comparable yield, should it do so at the pricing date or the issue date? The regulations seem to provide, quite clearly, that both are "determined" as of the issue date.[270] However, the comparable yield is the "yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument (the comparable fixed rate debt instrument) including the level of subordination, term, timing of payments, and *general market conditions*."[271] Since the issuer finalizes the terms of a structured note on the *pricing* date, it is possible that the comparable yield should be based on the conditions pervading at the pricing date. Under this interpretation, although the comparable yield and projected payment schedule are "specified" on the issue date, they are actually computed on the pricing date. The virtue of this approach is that market events occurring after the note terms are finalized would have no effect on the issuer's and holder's taxable income. In other words, reflecting the market conditions that exist at the issue date would not accurately reflect the value of the contingencies

[268] *See* Marian, *supra* note 6, at 332.

[269] *See* N.Y. State Bar Ass'n, *Report on Ambiguities and Uncertainties in the Original Issue Discount Regulations* (May 5, 2010), at 30–34.

[270] *See* Treas. Reg. § 1.1275-4(b)(3)(i) ("The comparable yield is determined as of the debt instrument's issue date."); Treas. Reg. § 1.1275-4(b)(3)(ii) ("The projected payment schedule is determined as of the issue date . . . .").

[271] Treas. Reg. § 1.1275-4(b)(4)(i) (emphasis added).

embedded in the earlier economic deal struck between the issuer and the holder on the pricing date.[272]

2. Market Practice

For the reasons stated above, the general market consensus among structured note practitioners is that the comparable yield and the projected payment schedule should be determined as of the pricing date. This approach also accords with the practical reality that the documents delivered at the issue date, which set forth the comparable yield and the projected payment schedule, generally are prepared *before* the issue date.[273]

iii. Overlap Between the VRDI and Option Presumption Rule

1. The Problem

Recall that Treas. Reg. § 1.1272-1(c)(5) (the "Option Rule") provides that "an issuer is deemed to exercise or not exercise an option or combination of options in a manner that minimizes the yield on the debt instrument and a holder is deemed to exercise or not exercise an option or combination of options in a manner that maximizes the yield on the debt instrument." However, this rule applies "only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date."[274] Because the amounts payable on a VRDI are, by definition, variable, it is not clear whether the timing and amount of payments of each payment schedule of a VRDI are known, and, thus, it is not clear whether the Option Rule can apply to a VRDI.[275]

For example, assume a holder purchases, for $1,000, a five-year fully principal-protected note that pays SOFR plus 2% for the first two years and SOFR plus 5% for the final three years. The issuer has an option to call the structured note at the end of year two. Assume that, on the issue date, SOFR is 4%. If the Option Rule applies the equivalent fixed rate debt instrument would be a two-year note bearing QSI at 6% (because the issuer would be deemed to call the note at the end of year two).[276] If the Option Rule does not apply, the equivalent fixed rate debt instrument would

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[272] *See* T.D. 8674 (June 11, 1996) (providing that "a taxpayer computes interest accruals . . . by *setting* a payment schedule as of the issue date") (emphasis added). *See also* Treas. Reg. § 1.1275-4(b)(4) (providing that the comparable yield and projected payment schedule be "reasonable, are based on reliable, complete, and accurate data, and are made in good faith"); Treas. Reg. § 1.1275-4(b)(4)(i)(A) (providing that the comparable yield must be a "reasonable" yield for the issuer).

[273] *Cf.* Treas. Reg. § 1.871-15(g)(2)(ii) ("The calculation time for a potential Code Sec. 871(m) transaction is the earlier of when the potential Code Sec. 871(m) transaction is priced and when the potential Code Sec. 871(m) transaction is issued.").

[274] Treas. Reg. § 1.1272-1(c)(1).

[275] *But see* N.Y. State Bar Ass'n, *supra* note 269, at 26 ("[O]ne may also be able to argue that as practical matter such a note implicitly provides for a number of alternative payment schedules the timing and amount of which are known because all reasonably possible outcomes can still be known as of the issue date.").

[276] This is similar to the analysis of the step-up note discussed in 0. *supra*.

be a five-year note that pays 6% for the first two years and 9% for the final three years and, thus, the note would bear OID.

2. Market Practice

Most practitioners take the position that the Option Rule *does* apply to VRDIs. The regulations state that the taxpayer must "[d]etermine the amount of qualified stated interest and OID with respect to the equivalent fixed rate debt instrument."[277] Because the equivalent fixed rate debt instrument has known payment schedules, the Option Rule can apply. Accordingly, most structured notes tax practitioners are comfortable applying the Option Rule to VRDIs, after substituting the relevant fixed rates for the relevant floating rates, as prescribed under the VRDI regulations.[278]

iv. Impossible Payment Schedules

1. The Problem

Readers may want to refer back to Part II.b.ii.2.C for a discussion of how U.S. Holders generally account for CPDIs. Occasionally, a structured note issuer may be required to assemble an "impossible" payment schedule. For example, assume a holder purchases, for $1,000, a five-year note with no stated interest that pays a digital return at maturity. The note will pay $1,200 at maturity if the S&P 500 index increases from the issue date to the maturity date; otherwise, the holder will receive the par amount of $1,000 at maturity. Assume that the SMLTN rule does not apply and, thus, this note is treated as a CPDI.

Assume the issuer's comparable yield is 2.5%, and this is higher than the applicable federal rate. Since the projected payment schedule must produce the comparable yield,[279] the issuer projects a single payment in year five of $1,282 (*i.e.*, $1000 accruing 2.5% over five years with semi-annual compounding). However, it is impossible for the holder to receive $1,282! The holder will receive either the par amount of $1,000 or $1,200 at maturity. This is awkward at best. The CPDI regulations provide that if a contingent payment is based on market information, the amount of the projected payment is the forward price of the contingent payment. How can the forward price of a payment of $1,200 be $1,282?![280]

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[277] Treas. Reg. § 1.1275-5(e)(3)(iii).

[278] *See* N.Y. State Bar Ass'n, *supra* note 269, at 44–46; Jason Schwartz & David S. Miller, *Collateralized Loan Obligations*, 6585-1st TAX MGMT. PORT. (BNA), at Section II.C.3.e (2024).

[279] *See* Treas. Reg. § 1.1275-4(b)(4)(i)(C).

[280] A similar issue can arise with a Debt Note that pays "digital" contingent coupons—*i.e.*, coupons that are fixed in amount but payable only if the Reference Asset is trading above a certain threshold. Anecdotally, projections of the coupons based on forward prices, which the CPDI regulations require in setting the projected payment schedule—see Treas. Reg. § 1.1275-4(b)(4)(ii)(A)—will almost never match the amount of payment actually possible. As a matter of basic economics, the projections will always be some amount lower than the actual potential digital payment (because they are adjusted for both time value and the risk that the coupon may not be paid). Moreover, the digital

2. Market Practice

The general market consensus appears to be that the comparable yield trumps—*i.e.*, the issuer's projected payment schedule should specify a payment of $1,282 at maturity, even though this payment is not possible under the terms of the note. The logic behind this approach is the notion that, as noted above, the projected payment schedule *must* produce the comparable yield. Moreover, this is the only approach that produces a rational result: the dominant theme of the CPDI regulations is that the holder should accrue OID at the comparable yield. Nevertheless, one is left with a queasy feeling when assembling an "impossible" payment schedule.

c. Tax Ownership & Tax Attributes of the Reference Asset

It is important to note that most structured note tax practitioners take the position that a structured note generally does not convey beneficial ownership of the Reference Asset for U.S. federal income tax purposes, even though a structured note may convey the opportunity for gain and risk of loss with respect to the Reference Asset. A full discussion of tax ownership is beyond the scope of this paper or any single article.[281] It is certainly true that tax ownership of property turns on all the facts and circumstances including which party has the opportunity for gain and risk of loss with respect to the asset.[282] However, it is sufficient to note here that Reference Assets are generally fungible property, and the critical factor in identifying the tax owner of fungible property is the power to dispose of the asset.[283]

In general, the structured note itself will not legally or economically constrain the issuer to hedge in any particular way. For instance, the issuer of the structured note could hedge by acquiring the Reference Asset itself, hedge by acquiring derivative exposure with respect to the Reference Asset, hedge on a "macro" basis by netting its exposure across all of its issued structured notes, or not hedge at all. Even if the issuer holds the Reference Asset as a hedge, the issuer generally will retain in all cases the power to dispose of the Reference Asset as it sees fit. Accordingly, outside of rare and unusual cases, it is unlikely that a structured note will convey tax ownership to the holder of the Reference Asset.

Relatedly, certain tax "attributes" of the Reference Asset should not adhere to the structured note. As James Peaslee has said, "a derivative contract is distinct from the underlying asset and can produce different results from a direct ownership interest."[284] For example, if the

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coupon projections may need to be adjusted to produce the comparable yield and may, at times, need to be projected in an amount that exceeds the possible payment.

[281] For more on the subject, the author recommends the classics: Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 B.U. L. REV. 431 (2005); Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 TAXES 783 (1993).

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

[283] *See, e.g.*, *Provost v. United States*, 269 U.S. 443, 455 (1926); *Miami National Bank v. Commissioner*, 67 T.C. 793 (1977); *Citizens National Bank of Waco v. United States*, 551 F.2d 832 (Ct. Cl. 1977); *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970); *Bickford-Smith v. United States*, 80 F. Supp. 660 (Ct. Cl. 1948).

[284] James S. Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 95 TAX NOTES 737 (2002) (arguing that the existence of Section 1260, which attempts to conform to some extent the tax treatment of a

Reference Asset is a grantor trust that holds "collectibles," as defined in Code Sec. 408(m)—ownership of which is treated as beneficial ownership of the collectibles for U.S. federal income tax purposes—structured note tax practitioners generally are comfortable that the structured note itself should not be viewed as a collectible.[285]

Similarly, a structured note that references Code Sec. 1256 contracts generally should not itself be treated as a Code Sec. 1256 contract. Code Sec. 1256 provides that Code Sec. 1256 contracts are generally marked to market annually and generate 60% long-term capital gain and 40% short-term capital gain (regardless of holding period).[286] Putting aside Prepaid Derivative Notes linked to foreign currencies, which have been discussed elsewhere,[287] because structured notes are generally not listed or subject to the rules of a qualified board or exchange, it seems unlikely that they would fall within any of the categories of Code Sec. 1256 contracts.[288] Nevertheless, the matter is not free from doubt. As a result, some issues include cautionary Code Sec. 1256 disclosure along the following lines:

> If a Prepaid Derivative Note is linked to a Reference Asset that includes a regulated futures contract, it is possible that the IRS could assert that Code Sec. 1256 should apply to the Prepaid Derivative Note or a portion thereof.

d. Capital Gain upon Sale, Exchange, or Retirement

As discussed throughout Part II, there are many circumstances in which a sale, exchange, or retirement of a structured note gives rise to capital gain or loss. There are several circumstances in which a structured note tax practitioner faces complexity in arriving at this conclusion (or determining whether the gain or loss is short-term or long-term).

i. Holding Period Issues

Occasionally, questions arise as to how to compute a U.S. Holder's holding period which can impact whether gain or loss from sale, exchange, or retirement of the note is short-term or long-term. Given the preferential rates available for long-term capital gain, the stakes here are often material.

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long derivative to the treatment of its reference asset, demonstrates that the former can produce difference tax consequences form the latter).

[285] *See* Farber *supra* note 6, at 675 (stating that "it seems that section 1(h)(5) would not apply to derivative instruments linked to precious metals."). *See also id.*, at 675 n.141 (citing *Modesto Dry Yard, Inc. v. Commissioner*, 14 T.C. 374, 385, 387 (1950) and *Moody v. Commissioner*, 49 T.C.M (CCH) 514 (1985)).

[286] *See* Code Sec. 1256(a).

[287] *See* Farber *supra* note 6, at 674–75 (discussing whether such notes should be treated as "foreign currency contracts," as defined in Code Sec. 1256(g)(2)).

[288] *See generally* Code Sec. 1256(b)(1). The analysis of whether an exchange-traded note could be treated as a Code Sec. 1256 contract is more complex.

1. The Beginning: Issue Trade Date vs. Settlement Date

Since Debt Notes are invariably issued for money, it seems reasonably clear that the holding period of Debt Notes begins on the issue date—*i.e.*, the settlement date or closing date, as applicable, on which a substantial amount of the Debt Notes in the "issue" is sold for money.[289] This raises two questions: is the Debt Note "sold" on the issue date or the pricing date, and what does "substantial" mean? The latter question arises in the case of Debt Note reopenings. The New York State Bar Association Tax Section has discussed these questions in a thorough report, so they need not detain us here.[290] Suffice to say, the market generally views a U.S. Holders holding period as beginning on the "settlement date" of the issuance.

For a non-Debt Note (*i.e.*, a Prepaid Derivative Note), the question is whether the holding period begins on the pricing date or the settlement date. In Rev. Rul. 66-97,[291] the IRS ruled that, in computing the holding period of exchange-traded stocks and bonds, the property is "considered acquired . . . on the respective 'trade dates.'" However, since the Revenue Ruling addresses only exchange-traded stocks and bonds, not derivative financial instruments like Prepaid Derivative Notes that are sold off-exchange, most structured note tax practitioners generally believe there is a material possibility that the holding period of a Prepaid Derivative Note begins on the *settlement date*.

2. The End: Payment Observation Date vs. Settlement Date

A similar issue arises in determining the date on which a U.S. Holder's holding period in a Prepaid Derivative Note ends.

Assume that, on January 1, 2026, a holder purchases, for $1,000, a five-year note that makes no interim payments. At maturity, the holder will receive $1,000 plus (or minus) $1,000 times the percentage change in the value of the S&P 500 from the issue date to the instrument's maturity, subject to a cap of $1,400. However, the issuer can call the note within approximately one year of the issue date. Specifically, if, on December 28, 2026 (the "Call Observation Date"), the value of the S&P 500 is equal to or greater than its value on the issue date, then the issuer will call the note. The call will settle on January 3, 2027 (the "Call Settlement Date").

If the issuer calls, the question is whether the holding period will end on the Call Observation Date or the Call Settlement Date. If the holding period ends on the Call Observation Date, the holder's holding period will be less than one year—*i.e.*, January 1, 2026 to December 28, 2026—and gain or loss will be short-term. By contrast, if the holding period ends on the Call *Settlement* Date, the holder's holding period will be more than one year—*i.e.*, January 1, 2026 to January 3, 2027—and gain or loss will be long-term. There are compelling arguments for both

[289] *See* Treas. Reg. § 1.1273-2(a)(2).

[290] *See* N.Y. State Bar Ass'n, *Report on Ambiguities and Uncertainties in the Original Issue Discount Regulations*, at 30–35 (May 5, 2010).

[291] 1966-1 C.B. 190. *See also* Rev. Rul. 93-84, 1993-2 C.B. 225.

approaches. The Call Observation Date is the date that "locks in" the amount that the U.S. Holder is entitled to receive. All that follows—*i.e.*, the transmission and settlement of the payment from the issuer to the U.S. Holder—is merely perfunctory. By contrast, the Call Settlement Date is the date on which the U.S. Holder actually receives the cash; prior to that date, the U.S. Holder is neither in actual receipt nor constructive receipt of the funds. Most structured note tax practitioners believe that it is more appropriate to look to the Call Settlement Date. However, many Prepaid Derivative Notes that implicate this or similar fact patterns usually include tax disclosure along the following lines:

> It is possible that the IRS could assert that your holding period with respect to the Prepaid Derivative Notes ends on the date on which the amount you are entitled to receive is determined, even though you will not receive any amounts prior to the relevant Settlement Date. Accordingly, such holding period may be treated as one year or shorter even though you may only be entitled to receive cash on a date that is more than one year from the date your holding period begins.

ii. Scope of Code Sec. 1234A—Non-Capital Asset References

U.S. Holders are generally assumed to hold Prepaid Derivative Notes as capital assets, so when a U.S. Holder sells or exchanges a Prepaid Derivative Note, it is reasonably clear that the U.S. Holder recognizes capital gain or loss. When a Prepaid Derivative Note is *retired*, however, the analysis is more complex.

Generally, Code Sec. 1234A provides as follows:

> [G]ain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset.

In the case of a Prepaid Derivative Note linked to a Reference Asset that clearly would be a capital asset in the hands of the U.S. Holder (*e.g.*, a stock or a basket or index of stocks, a commodity, etc.), it seems relatively noncontroversial to conclude that gain or loss upon retirement should be capital gain or loss.[292]

Complexity arises, however, if a Prepaid Derivative Note is linked to a Reference Asset that is harder to place in the category of "capital asset." The deep mysteries of Code Sec. 1234A are beyond the scope of this paper, and have been discussed elsewhere.[293] The discussion below is but a brief summary of some of the key analytical points.

Assume a holder purchases, for $1,000, a five-year note that makes no interim payments. At maturity, the holder will receive $1,000 plus (or minus) $1,000 times the percentage change in

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[292] *See* Code Sec. 1234A.

[293] *See* Michael S. Farber, *Capital Ideas: The Taxation of Derivative Gains and Losses*, 126 TAX NOTES 1493 (2010).

the value of the consumer price index (the "CPI") from the issue date to the instrument's maturity, subject to a cap of $1,400. At maturity, the CPI has skyrocketed due to inflation, and the issuer pays the holder $1,400. Does the holder recognize $400 of long-term capital gain?

The answer turns on whether the structured notes tax practitioner believes that the note described above is a "right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer."[294] On the one hand, the CPI clearly is not—in and of itself—a capital asset. It is an index published monthly by the U.S. Bureau of Labor Statistics that measures the average change over time in the prices paid by urban consumers for a market basket of goods and services.[295]

There are at least three potential conceptual approaches that would treat a retirement of the CPI-linked Prepaid Derivative Note as giving rise to capital gain or loss.

1. The Bootstrap Argument

Commentators and the IRS have argued that Code Sec. 1234A applies when the contract itself is a capital asset. Farber calls this the (strong-form) "bootstrap" argument.[296] Just as one might be said to "pull himself up by his bootstraps," under this view, Code Sec. 1234A applies to the termination of a Prepaid Derivative Note that is a capital asset in the taxpayer's hands even if the Prepaid Derivative does not reference property that is, or would be, a capital asset—*i.e.*, the Prepaid Derivative Note is a "right or obligation" with respect to *itself*.

The 2004 proposed regulations under Section 1234A appear to endorse the bootstrap argument.[297] The preamble to those regulations provides as follows: "Any gain or loss arising from a termination payment [with respect to an NPC], however, is treated as capital gain or loss pursuant to the proposed regulations under section 1234A."[298] This appears to be the case *regardless of whether the reference asset of the NPC is itself a capital asset*. These regulations have not been finalized and their effective date appears to be prospective.[299]

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[294] Code Sec. 1234A.

[295] CPI Home, https://www.bls.gov/cpi/ (last visited Oct. 5, 2025).

[296] Farber, *supra* note 293, at 1497 ("On a related note, many have said that Code Sec. 1234A(1) could be applied in a bootstrap fashion: the termination of any contract that is a capital asset (or that would be a capital asset in the taxpayer's hands) — including the contract on which you're performing your Code Sec. 1234A analysis — is the termination of a right or obligation regarding a capital asset (the contract itself). I have some doubt as to whether this 'strong form' of bootstrap argument would be persuasive if challenged. . . . And absent the strong form of bootstrap argument, Code Sec. 1234A doesn't seem to apply clearly to many things that one might conclude it should apply to (because without application of the rule, the very whipsaw the section was intended to prevent is available to taxpayers).").

[297] *See* Prop. Reg. § 1.1234-1 (2004).

[298] REG-166012-02, *Notional Principal Contracts; Contingent Nonperiodic Payments*, I.R.B 2004-13, 655 (Feb. 26, 2004).

[299] The Internal Revenue Manual states that taxpayers generally may rely on proposed regulations: "Proposed regulations provide guidance concerning Treasury's interpretation of a Code section. . . . Taxpayers may rely on a

However, other commentators have rejected the bootstrap argument and argued that Section 1234A applies only to derivatives with respect to capital assets.[300] This view holds that Section 1234A requires two elements: (i) a right or obligation and (ii) an underlying capital asset other than the right or obligation. Prior to the amendments to the Section 165(i) regulations, proponents of this view argued that Code Sec. 1234A did not apply to abandonments of ownership interests in capital assets, because an ownership interest is not a right or obligation—*i.e.*, the argument is that a capital asset is not a "right or obligation" *with respect to* a capital asset.[301]

Moreover, in *Pilgrim's Pride Corporation v. Commissioner*,[302] Fifth Circuit rejected the bootstrap argument with respect to Section 1234A based on legislative history.[303] The court held that corporate stock was not a right with respect to a capital asset; rather, the stock was an ownership interest in a capital asset. The precise issue in *Pilgrim's Pride*—whether the abandonment of corporate stock gives rise to a sale or exchange of a capital asset or otherwise gives rise to capital gain or loss—has been addressed by 2008 amendments to the regulations under

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proposed regulation, although they are not required to do so. Examiners, however, should follow proposed regulations, unless the proposed regulation is in conflict with an existing final or temporary regulation." I.R.M. 4.10.7.2.3.3 (Jan. 1, 2006).

[300] David C. Garlock, *The Proposed Notional Principal Contract Regulations: What's Fixed? What's Still Broken?*, 102 TAX NOTES 1515, 1519 (2004) ("Therefore, if a swap is to be viewed as a right or obligation with respect to property, the property must be the swap itself. . . . Purely as a matter of statutory construction, there are significant problems with that reading of the law. First, and most obvious, it strains the English language to say that a contract is a right or obligation with respect to itself. Second, reading Code Sec. 1234A(1) that way would make Code Sec. 1234A(2) pure surplusage. That paragraph makes the section applicable to a Code Sec. 1256 contract that is not described in paragraph (1) but which is a capital asset in the hands of the taxpayer. If every contract were a right or obligation with respect to itself, it would be covered by paragraph (1) if it were a capital asset, so there would be no need for paragraph (2).").

[301] One article argued that Fifth Circuit in *Pilgrim's Pride* (discussed *infra*) should conclude that Code Sec. 1234A does not apply to ownership rights, but rather applies only to derivatives, which is the conclusion that the Fifth Circuit ultimately reached. Linda E. Carlisle & Sarah K. Ritchey, *The Schizophrenic World of Code Sec. 1234A*, 12 J. TAX'N FIN. PRODS 13, 17 (2015) ("[T]he Fifth Circuit should look to the intent of Congress when Code Sec. 1234A was enacted, conclude that Code Sec. 1234A applies only to derivative rights with respect to personal property, and remand the case for further consideration under Code Sec. 165(g)."). William R. Davis, *Practitioners Welcome Pro-Taxpayer* Pilgrim's Pride, 146 TAX NOTES 1078 (Mar. 2, 2015) ("'This case was decided correctly,' Jeffrey W. Maddrey of PricewaterhouseCoopers LLP said. 'It was clear to me that abandonments were never covered by Code Sec. 1234A because Code Sec. 1234A applies to derivatives only, and it's refreshing to see that the Fifth Circuit agreed.'")

[302] 779 F. 3d 311 (5th Cir. 2015).

[303] One leading practitioner in the area of financial products has concluded that the Fifth Circuit's decision in *Pilgrim's Pride* supports treating termination of interest rate swap as giving rise to ordinary income or loss. *See* Linda E. Carlisle, *Pilgrim's Pride —The Fifth Circuit Gets It Right!*, 12 J. TAX'N FIN. PRODS 11, 12–13 (2015) ("The [Fifth Circuit] then held that 'By its plain terms,' Code Sec. 1234A(1) applies to the termination of rights or obligations with respect to capital assets, such as derivative or qualifying rights to buy or sell capital assets, but not to the termination of ownership rights in a capital asset. . . . [T]he phrase 'right or obligation with respect to' referenced the forward contract rights, which are derivative or contractual rights to buy or sell capital assets, not ownership rights. . . . *[A] loss on the termination of ownership rights in a derivative contract that is not a Code Sec. 1256 contract, such as an interest rate swap, would not be classified as a capital loss under Code Sec. 1234A(1) because no derivative rights with respect to such contract would be terminated, or as a capital loss under Code Sec. 1234A(2) because such contract would not be a Code Sec. 1256 contract.*") (emphasis added).

Section 165.[304] However, practitioners have explicitly noted that *Pilgrim's Pride* has implications for the viability of the bootstrap argument with respect to terminations of derivatives, like the retirement of Prepaid Derivative Notes.[305] Some of these practitioners go as far as to argue that the Section 1234A proposed regulations may be invalid.[306]

At the end of the day, although the bootstrap argument may be available, the waters are muddy on whether it is the correct interpretive approach to Code Sec. 1234A.

2. The Straddle Position Argument

One leading commentator has argued that contracts subject to the straddle rules must necessarily be subject to Code Sec. 1234A.[307] The straddle rules, which are linked to Code Sec. 1234A by history,[308] defer or capitalize losses with respect to offsetting positions in respect of "personal property of a type which is actively traded" and, generally speaking, wreak many other evils upon unsuspecting taxpayers who happen to find themselves with offsetting positions.[309] Code Sec. 1234A applies to "a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer." The argument goes that "personal property of a type which is actively traded" is necessarily a category of items that is

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[304] *See* Treas. Reg. § 1.165-5(i).

[305] Davis, *supra* note 301, at 1078 ("Under the Tax Court's approach, Code Sec. 1234A would presumably apply in such cases as long as the taxpayer holds the derivative or contractual right as a capital asset, [Jeff] Hochberg [of Sullivan & Cromwell LLP] said. But under the Fifth Circuit's approach, Code Sec. 1234A may not apply because the only capital asset would be the derivative or contractual right that is held by the taxpayer, which is similar to the stock held by the taxpayer, he said.").

[306] Linda E. Carlisle, *Gain or Loss on Termination, in, Examining the Straddle Rules After 25 Years*, 125 TAX NOTES 1301, 1320 (2009) ("This regulatory interpretation [in the proposed regulations under Code Sec. 1234A] is based on the view that Code Sec. 1234A(1) provides that the termination of a contract that is a capital asset gives rise to gain or loss regardless of whether the contract is with respect to property that is or would be a capital asset in the hands of the taxpayer. Thus, it is unclear whether these regulations, which have been proposed for almost a decade, comport with the legislative history of Code Sec. 1234A. . . . If Code Sec. 1234A is applied to the termination of a contract that is not held by a dealer in those contracts (that is, is a capital asset) without regard to whether the contract relates to property that is a capital asset, Code Sec. 1234A would apply to all terminations of regular business service and inventory contracts and would convert gain or loss on the terminations of those contracts to capital gain or loss. This is contrary to some private rulings the IRS has issued dealing with payments to terminate burdensome uneconomic fuel transportation contracts (see, for example, TAM 20045203355)."); Davis, *supra* note 301, at 1078 ("[David B. Cubeta of Miller & Chevalier] said that it has always been an issue of how to apply Code Sec. 1234A to swaps in the context of the traditional view, which the Fifth Circuit takes, in which the derivative right must be in other property. In 2004 Treasury issued Prop. Reg. § 1.1234A-1, which treats the termination of an interest rate swap as one subject to Code Sec. 1234A. 'There is an open question of what is going to happen to this regulation,' Cubeta said.").

[307] *See* Farber, *supra* note 293, at 1499 n.22 ("In any event, given that [after the 1997 amendment] Code Sec. 1234A no longer turns on active trading, and the only question under that section is whether a contract involves rights or obligations with respect to 'property' that is or would be a capital asset in the taxpayer's hands, I think the syllogism that to be a straddle position, something must also be subject to Code Sec. 1234A, is sound.").

[308] Both sets of rules were enacted as part of the Economic Recovery Tax Act of 1981, and both were aimed at curbing tax-motivated straddle transactions.

[309] Code Sec. 1092(d)(1).

larger than, and subsumes, "right[s] or obligation[s] . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer." Because, as a matter of statutory interpretation, the latter category must be narrower than the former category—*i.e.*, every right or obligation with respect to property that would be (on acquisition) a capital asset must be a position with respect to personal property of a type which is actively traded—every position that is a straddle position must necessarily also be subject to Code Sec. 1234A (at least in the hands of a nondealer).

Accordingly, analytically, in determining whether a contract is within the scope of Section 1234A, Farber's view suggests that one might analyze first whether a contract is a potential straddle position and use that conclusion to reach a conclusion with respect to Section 1234A.[310] Farber appears to conclude, on this basis, that Section 1234A applies to terminations of interest rate swaps.[311] It seems relatively straightforward to conclude that the Prepaid Derivative Note linked to the CPI in the example above should be a straddle position. It follows, then, that the Prepaid Derivative Note should be subject to Code Sec. 1234A.

3. The Anti-Abuse Argument

It is easy to see how taxpayers could game the system if retirement of the Prepaid Derivative Note in the example above did *not* give rise to capital gain or loss. If, around the time of maturity, the Prepaid Derivative Note were out of the money (*i.e.*, it was highly likely that the U.S. Holder would suffer a loss), then the U.S. Holder could hold the note until retirement and claim an ordinary deduction with respect to the retirement of the note. If, however, the Prepaid Derivative were in the money (*i.e.*, it was highly likely that the U.S. Holder would recognize a gain), the U.S. Holder could attempt to sell or exchange the note in a taxable transaction and recognize a capital gain. As noted above, upon sale or exchange of a Prepaid Derivative Note, it is reasonably clear that a U.S. Holder recognized capital gain or loss without regard to the nature of the reference asset.

This is almost identical to the type of perceived abuse that Congress enacted Code Sec. 1234A to prevent. Prior to Code Sec. 1234A, taxpayers would take advantage of the "extinguishment doctrine," which is a line of cases generally holding that "gain or loss resulting from a contract cancellation should be treated as ordinary gain or loss because the underlying contract or asset 'disappears' when the contract is canceled. Since the asset simply vanishes, there

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[310] *Id.* at 1499 ("But because the straddle rules are designed the way they are, if we are to conclude that a position with respect to LIBOR -- or life settlements, or inflation -- can be a straddle position, we are required to conclude that it is a [position with respect to actively traded personal property]. And it is absurd to conclude that a position that is with respect to [actively-traded personal property] is not a position with respect to 'property which is (or on acquisition would be) a capital asset,' assuming the taxpayer isn't a dealer in the property. So any index or linkage that can form the basis for a straddle position must be subject to Code Sec. 1234A -- whatever one has to do to reach that result.").

[311] *Id.* at 1505 ("So are swaps linked to LIBOR really PsWRATPP [*i.e.*, positions with respect to actively traded personal property]? It is sufficient to say yes -- indeed, they must be -- because the straddle rules are drafted the way they are. We know that because if a LIBOR swap isn't a potential straddle position, the system doesn't work. . . . Thus, offsetting positions with respect to LIBOR are -- must be -- straddle positions. So they're PsWRATPP. And it follows that they are (must be) rights or obligations with respect to property that on acquisition would be a capital asset, at least in the hands of a nondealer in that property.").

can be no 'sale or exchange' and, thus, no capital gain or loss."[312] If a derivative were in the money, the taxpayer would sell the derivative to a third party and recognize a capital gain. If the derivative were out of the money, the taxpayer would hold it to maturity, and claim an ordinary deduction under the extinguishment doctrine. Congress enacted Code Sec. 1234A to curtail precisely this type of cherry picking.

If the scope of Code Sec. 1234A were so limited that it would not apply to Prepaid Derivative Notes linked to inflation indices, interest rates, or other Reference Assets that are not easy to categorize as potential capital assets, U.S. Holders of such notes could easily undermine the policy of Code Sec. 1234A by treating gains as capital (upon sale or taxable exchange) and losses as ordinary (upon retirement). This result would make little sense. Accordingly, it makes sense that Code Sec. 1234A would apply to such Prepaid Derivative Notes to prevent cherry picking.

4. Market Practice

Most structured note tax practitioners generally believe, at least at some level of comfort, that the retirement of a Prepaid Derivative Note linked to the CPI, interest rates, or another Reference Asset that is not clearly a capital asset generally gives capital gain or loss to a U.S. Holder under Code Sec. 1234A. As discussed above, one can reach this result by applying the bootstrap analysis (*i.e.*, the Prepaid Derivative Note itself is a capital asset and this is sufficient to bring it into the ambit of Code Sec. 1234A), the straddle analysis (*i.e.*, the Prepaid Derivative Note should be a straddle position and thus it should be subject to Code Sec. 1234A), or the anti-abuse argument (*i.e.*, failure to apply Code Sec. 1234A to retirement would allow U.S. Holders to cherry-pick their character by either selling or retiring depending on the note's performance). Other theories for capital treatment upon termination may exist. Nevertheless, given the uncertainty in this area, many issuers include tax disclosure regarding the risk that the IRS could disagree.

iii. Escalating Call Premium

Assume that, on January 1, 2026, a holder purchases, for $1,000, a five-year note that makes no interim payments. At maturity, the holder will receive $1,000 plus (or minus) $1,000 times the percentage change in the value of the S&P 500 from the issue date to the instrument's maturity, subject to a cap of $1,400. However, the issuer can call the note at the end of any calendar year. Let's say that for purposes of this note, the call is purely at the issuer's discretion.[313] The amount that the holder can receive upon a call increases with each call date. Thus, if the note is called on January 2, 2027, the investor will receive $1,050. If the note is called on January 2, 2028, the holder will receive $1,100. So on and so forth.

The better answer appears to be that the payment of the retirement amount if the note is called should be capital gain or loss for a U.S. Holder under Code Sec. 1234A. However, this is

[312] *Wolff v. Commissioner*, 148 F.3d 186, 190 (2d Cir. 1988) (citing *Commissioner v. Starr Bros.*, 204 F.2d 673 (2d Cir. 1953); *General Artists Corp. v. Commissioner*, 205 F.2d 360 (2d Cir. 1953); *Commissioner v. Pittston Co.*, 252 F.2d 344 (2d Cir. 1958)).

[313] Some notes in this category provide that the note will be called automatically if the reference is performing above a certain threshold.

not entirely clear. Since the call "premium"—*i.e.*, the excess of the retirement amount over the principal amount of the note—escalates annually, some structured notes tax practitioners are concerned that the call premium could be treated as ordinary income, because it could be viewed as attributable to the time value of money.[314] Accordingly, some notes with this type of structure contain disclosure providing that the treatment of the call "premium" as capital gain is not certain.

iv. Notes with Embedded Short Exposure[315]

Assume that, on January 1, 2026, a holder purchases, for $1,000, a five-year note that makes no interim payments. At maturity, if the value of the S&P 500 is *greater than* the initial value, then the holder will receive $1,000 plus $1,000 times the percentage change in the value of the S&P 500 from the issue date to the instrument's maturity. If, however, the value of the S&P 500 is less than its initial value, but has not declined by more than 10%, then the holder will receive the *absolute value* of the S&P return. For example, if the S&P 500 declines by 5%, the holder will receive $1,050 at maturity (a positive return of 5%). If the value of the S&P 500 is more than 10% less than its initial value, then the holder suffers a one-to-one loss based on the percentage decline of the S&P 500.

Since this note is treated as a Prepaid Derivative, if the holding period requirement is satisfied, the better view appears to be that the retirement of the note should give rise to long-term capital gain or loss, regardless of the performance of the S&P 500 upon the maturity of the note. However, the embedded short exposure in the note's return profile introduces some complexity. Under Code Sec. 1233(b), upon closing a "short sale," a taxpayer generally recognizes short-term capital gain if (i) the taxpayer held substantially identical property for one year or less upon entering into the short sale or (ii) the taxpayer acquired substantially identical after entering into the short sale but before it closed. Moreover, under Code Sec. § 1234B(b), gain or loss from the sale, exchange, or termination of a short "securities futures contract" generally is short-term capital gain or loss. Although the Prepaid Derivative Note is not technically a "securities futures contract,"[316] the shore sale rules and Code Sec. 1234B suggest that it is not a foregone conclusion that a U.S. Holder would recognize long-term capital gain with respect to a Prepaid Derivative Note that provides the U.S. Holder with short exposure. On the other hand, it is certainly true that not all derivatives with short exposure give rise to short-term capital gain or loss: although the matter is not free from doubt, the termination of a "short" NPC with a long-term holding period generally should give rise to long-term capital gain or loss.[317]

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[314] An alternative theory could view the excess of the retirement amount over the principal amount as premium paid with respect to a call option written by the U.S. Holder. If this were the correct treatment of the call "premium," it should give rise to short-term capital gain. *See* Code Sec. 1234(b).

[315] For an excellent (but, sadly, brief) discussion of these issues, see Farber, *supra* note 6, at 678–79.

[316] *See generally* Code Sec. 1234B(c) (defining a "'securities futures contract' as any security future (as defined in section 3(a)(55)(A) of the Securities Exchange Act of 1934, as in effect on December 21, 2000)").

[317] *See* Code Sec. 1234A; Prop. Reg. § 1.1234A-1(a) ("If a taxpayer has a position in a notional principal contract governed by the rules of Treas. Reg. § 1.446-3, any gain or loss arising from a termination payment as defined in Treas. Reg. § 1.446-3(h)(1) is treated as gain or loss from a termination of the notional principal contract.").

In the case of the note in the example above, the U.S. Holder is "short" the S&P 500 to the extent the S&P 500 at maturity is below its initial value but has not declined by more than 10%. Accordingly, there is a question of whether the U.S. Holder of the Prepaid Derivative Note in the example above should recognize short-term capital gain if it receives the "absolute return."

There is no comprehensive definition of "short sale" for U.S. federal income tax purposes. However, the Code makes clear that a conventional put option is a "short sale" for purposes of Code Sec. 1233(b).[318] As a result, it is not sufficient to argue that the Prepaid Derivative Note is an asset in the taxpayer's hands whereas a short sale is generally a liability, and thus Code Sec. 1233(b) should not apply—a put option is an asset in a taxpayer's hands as well. However, in *Carborundum Co. v. Commissioner*,[319] the Tax Court held that, even if a derivative is a "short sale" for purposes of Code Sec. 1233(b), a taxable sale of the derivative does not trigger the application of Code Sec. 1233(b). What about terminations of derivatives, which are not, in and of themselves, sales? Under Code Sec. 1234A, the termination of a derivative is a "sale or exchange."[320] Accordingly, one can argue that the logic of *Carborundum* should extend to the termination of a derivative as well.

At the end of the day, the better answer appears to be that, notwithstanding Code Sec. 1233(b), Code Sec. 1234B, and the principles that underpin them, the Prepaid Derivative Note is a capital asset in the hands of a U.S. Holder and its termination should give rise to long-term capital gain or loss if the U.S. Holder's holding period in the Prepaid Derivative Note exceeds one year. Nevertheless, some structured notes tax practitioners include disclosure for notes with short exposure warning U.S. Holders that this conclusion is not free from doubt.

e. Code Sec. 1260

i. Overview

Congress enacted Code Sec. 1260 to prevent investors from entering into derivatives with respect to property that would not itself give rise exclusively to long-term capital gain (*e.g.*, an interest in a partnership) and claiming that the sale, exchange, or termination of the derivative gives rise to long-term capital gain.[321] The Senate Report accompanying the enactment of Code Sec. 1260 describes a prototypical transaction:

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[318] See Code Sec. 1233(b) ("For purposes of this subsection, the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale."). See also Treas. Reg. § 1.1233-1(c)(3).

[319] 74 T.C. 730 (1968). *See also American Home Prods. v. United States*, 601 F2d 540 (Ct. Cl. 1979) (holding that the assignment of a contract to sell British pounds produced long-term capital gain not subject to Code Sec. 1233(b) because the taxpayer did not hold or acquire "substantially identical property," which was "an essential part of the statutory scheme"); I.T. 3721, 1945 C.B. 164 (concluding that the assignment of a contract to sell stock on a "when-issued" basis gave rise to long-term capital gain when the contract was been held for the long-term holding period); GCM 37332 (Nov. 25, 1977).

[320] *See* Code Sec. 1234A.

[321] *See* S. REP. NO. 106-120, at 202 (1999) ("The Committee is concerned with the use of derivative contracts by taxpayers in arrangements that are primarily designed to convert what otherwise would be ordinary income and short-

> One example of a conversion transaction involving a derivative contract is when a taxpayer enters into an arrangement with a securities dealer whereby the dealer agrees to pay the taxpayer any appreciation with respect to a notional investment in a hedge fund. In return, the taxpayer agrees to pay the securities dealer any depreciation in the value of the notional investment. The arrangement lasts for more than one year. The taxpayer is substantially in the same economic position as if he or she owned the interest in the hedge fund. However, the taxpayer may treat any appreciation resulting from the contractual arrangement as long-term capital gain. Moreover, any tax attributable to such gain is deferred until the arrangement is terminated.[322]

Congress enacted Code Sec. 1260 to curb both the deferral and character conversion benefits of these transactions. To address the potential conversion of ordinary income long-term capital gain, Code Sec. 1260(a)(1) requires that a taxpayer who has long-term capital gain from a "constructive ownership transaction" (a "COT") with respect to any "financial asset" to treat such gain as ordinary income to the extent that it exceeds the "net underlying long-term capital gain" ("NULTCG").[323] NULTCG means the aggregate net capital gain that the taxpayer would have had if the financial asset had been acquired for fair market value ("FMV") on the date the COT transaction was opened and sold for FMV on the date such transaction was closed and only gains and losses that would have resulted from such deemed ownership were taken into account.[324] This rule can be punitive: even if the "financial asset" would have given rise to short-term capital gain (which, unlike ordinary income, could be absorbed by capital losses without limitation), Code Sec. 1260 would recharacterize all of the gain as ordinary income. Moreover, to the extent that such gain is treated as a long-term capital gain after the applying the foregoing rule, the capital gain rates applicable to the gain are determined based on the rates that would have applied to the NULTCG.[325] For example, if the NULTCG were long-term capital gain from collectibles taxed at 28%,[326] a corresponding portion of the long-term capital from the COT will also be taxed at 28%.

To address deferral, Code Sec. 1260(b) imposes an interest charge with respect to the amount of gain treated as ordinary income under Code Sec. 1260(a)(1). Such recharacterized gain is treated as accruing over the taxpayer's holding period at the applicable federal rate.[327] An interest

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term capital gain into long-term capital gain. Of particular concern are derivative contracts with respect to partnerships and other pass-thru entities. The use of such derivative contracts results in the taxpayer being taxed in a more favorable manner than had the taxpayer actually acquired an ownership interest in the entity.")

[322] *Id.*

[323] Note that the term "constructive ownership transaction" is a misnomer. Code Sec. 1260 does not treat the holder of a COT as owning the underlying assets for U.S. federal income tax purposes.

[324] *See* Code Sec. 1260(e). NULTCG with respect to any financial asset is treated as zero unless the amount of NULTCG is established by clear and convincing evidence. *See id.* (flush language).

[325] *See* Code Sec. 1260(a)(2).

[326] *See* Code Sec. 1(h)(5).

[327] *See* Code Sec. 1260(b)(2).

charge is then imposed at the rate in Code Sec. 6601 for the deemed underpayment for each period.[328]

A "financial asset" means (i) any equity interest in any "pass-thru entity"—*viz*. a RIC, REIT, S corporation, partnership, trust, common trust fund, passive foreign investment company ("PFIC"),[329] or REMIC—or (ii) "to the extent provided in regulations," any debt instrument and any stock in a corporation which is not a "pass-thru entity."[330] A COT means (i) a long position under an NPC with respect to the financial asset,[331] (ii) a forward or futures contract to acquire the financial asset, (iii) a purchased call option and written put option if the options have substantially equal strikes and substantially contemporaneous maturity dates,[332] and (iv) "to the extent provided in regulations," one or more other transactions (or one or more positions) that have "substantially the same effect" as any of the foregoing.[333] An NPC is a COT only if the taxpayer (i) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on such financial asset for a specified period and (ii) is obligated to reimburse (or provide credit for) all or substantially all of any decline in the value of such financial asset.[334] The rules define "forward contract" as "any contract to acquire in the future (or provide or receive credit for the future value of) any financial asset."[335] Code Sec. 1260 directs the Treasury to prescribe regulations "to exclude certain forward contracts which do not convey substantially all of the economic return with respect to a financial asset."[336] However, as discussed further below, the Treasury has never promulgated guidance under Code Sec. 1260 and thus has largely left taxpayers and their advisors to their own devices.

ii. Spurned Delegation

Before we turn to how Code Sec. 1260 impacts structured notes, it is important to discuss all of the known unknowns. As noted above, as of the date of publication, there are no Treasury Regulations under Code Sec. 1260. For our purposes, there are three delegations to the Treasury in Code Sec. 1260: (i) to prescribe rules to include within the definition of "financial asset" both

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[328] *See* Code Sec. 1260(b)(1).

[329] This rule is applied without regard to the PFIC/CFC overlap rule in Code Sec. 1297(d). *See* Code Sec. 1260(c)(2)(G).

[330] *See* Code Sec. 1260(c).

[331] A person is treated as holding a long position under an NPC for this purpose if such person "has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on such financial asset for a specified period, and is obligated to reimburse (or provide credit for) all or substantially all of any decline in the value of such financial asset." Code Sec. 1260(d)(3).

[332] This combination of options is economically akin to a long forward contract.

[333] *See* Code Sec. 1260(d)(1).

[334] *See* Code Sec. 1260(d)(3).

[335] *See* Code Sec. 1260(d)(4).

[336] *See* Code Sec. 1260(g)(2).

debt instruments and stock in a corporations that are not "pass-thru entities," (ii) to define transactions or positions with "substantially the same effect" as enumerated COTs, and (iii) to exclude forward contracts that do not convey "substantially all" of the economic return of the relevant financial asset. The critical question is whether any of these rules are self-executing in the absence of regulations.

The law on when statutory provisions of this sort are self-executing in the absence of regulations—*i.e.*, when a court will fashion "phantom regulations" when the Treasury has not done so—is extremely confusing.[337] A full discussion of these issues is beyond the scope of this paper.[338] Nevertheless, to understand how Code Sec. 1260 may apply to structured notes, it is necessary to attempt a synthesis. The literature on such "spurned delegations" is helpful in clarifying these muddy waters. Phillip Gall has heroically attempted to reconcile the caselaw to divine the following principles:[339]

1. If the delegation to the Treasury is a "policy delegation"—*i.e.*, one granting "the authority to make the policy decision as to the circumstances in which the particular rule should be applied, if at all"—the provision is not self-executing. Courts have described policy delegations as "whether" regulations, as opposed to "how" delegations.[340]

    - In other words, if the Treasury is directed to define "whether" a rule applies, courts generally will not treat the relevant statutory rule as self-executing.[341] If, instead, the statute directs the agency to determine "how" a rule applies, courts ordinary will treat the statutory provision as self-executing even in the absence of regulations.[342]

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[337] *See, e.g.*, *Occidental Petroleum Corp. v. Commissioner*, 82 T.C. 819 (1984); *First Chicago Corp. v. Commissioner*, 88 T.C. 663 (1987), *aff'd*, 842 F.2d 180 (7th Cir. 1988); *Estate of Maddox v. Commissioner*, 93 T.C. 228 (1989); *Alexander v. Commissioner*, 95 T.C. 467 (1990); *Traylor v. Commissioner*, 59 T.C.M. (CCH) 93 (1990); *Estate of Hoover v. Commissioner*, 102 T.C. 777 (1994), *rev'd*, 69 F.3d 1044 (10th Cir. 1995), *acq.* 1999-1 I.R.B. 5; *H Enterprises International, Inc. v. Commissioner*, 105 T.C. 71 (1995); *Estate of Neumann v. Commissioner*, 106 T.C. 216 (1996); *Pittway Corp. v. United States*, 102 F.3d 932 (7th Cir. 1996); *International Multifoods Corp. v. Commissioner*, 108 T.C. 579 (1997); *Hillman v. Commissioner*, 114 T.C. 103 (2000), *rev'd*, 263 F.3d 338 (4th Cir. 2001); *15 West 17th St. LLC* v. *Commissioner*, 147 T.C. 557 (2016).

[338] For a thorough discussion of these issues, see Phillip Gall, *Phantom Tax Regulations: The Curse of Spurned Delegations*, 56 TAX LAW. 413 (2003); Amandeep S. Grewal, *Substance over Form? Phantom Regulations and the Internal Revenue Code*, 7 HOUS. BUS. & TAX L.J. 42 (2006); Jeffrey D. Hochberg, *Are Foreign SPACs PFICs and Should Investors (or the IRS) Care?*, TAX FORUM NO. 715 (2021); Robert J. Crnkovich & Kenneth H. Heller, *"To the Extent" Provisions: When Do They Operate Without Regulations?*, 76 J. TAX'N 176 (March 1992).

[339] *See* Gall *supra* note 338, at 444–47.

[340] *See Estate of Neumann*, 106 T.C. at 219 ("Are the regulations a necessary condition to determining 'whether' the GST tax applies, as petitioner contends, or do they constitute only a means of arriving at 'how' that tax, otherwise imposed by the statute, should be determined, as respondent contends.").

[341] *See id.*

[342] *See id*.

2. If the delegation requires regulations to be written to achieve a particular result—*i.e.*, it is a "mandatory regulation"—courts are more likely to treat the statute as self-executing.[343]

3. If the content of the regulations envisioned by Congress from the legislative history is unclear, courts will adopt one of three approaches:

- They may treat the delegation as a "policy delegation," and thus non–self-executing.[344]
- They may treat the delegation as self-executing if doing so will provide a benefit to the taxpayer.[345]
- They may refuse to treat the delegation as self-delegating because it is too unclear.[346]

1. Code Sec. 1260(c)(1)(B)—Debt and Stock

Most tax practitioners believe that, until the Treasury promulgates regulations, Code Sec. 1260 does not treat debt or stock in a corporation that is not a "pass-thru entity" as "financial assets."[347] The delegation in Code Sec. 1260(c)(1)(B) provides that such instruments are treated as "financial assets" "to the extent provided in regulations." The Tax Court has held that a delegation is a "policy delegation" (or, in other words, a "whether" delegation), and thus not self-executing, when the statutory provision is formulated using the language "to the extent provided in regulations prescribed the Secretary."[348] Moreover, treating debt or corporate non–"pass-thru

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[343] *See Occidental Petroleum Corp.*, 82 T.C. at 819.

[344] *See Hillman*, 263 F.3d at 338.

[345] *See First Chicago Corp.*, 88 T.C. at 663.

[346] *See* Gall *supra* note 338, at 446. Andy Grewal has developed a somewhat different taxonomy, divining three potential approaches from the "spurned delegation" caselaw. *See* Grewal *supra* note 338, at 47. The "legislative history" approach is as follows: if the legislative history provides sufficient guidance to enable a court to divine the content of "phantom" regulations to be applied, the court is more likely to treat the delegation as self-executing. *See, e.g.*, *International Multifoods Corp.*, 108 T.C. at 579. The "equity" approach is as follows: if treating the delegation as self-executing would benefit the taxpayer, courts are more likely to treat it as self-executing. *See, e.g.*, *Occidental Petroleum Corp.*, 82 T.C. at 819. The "whether or how" approach: courts are more likely to treat "policy" delegations as non–self-executing. *See Estate of Neumann*, 106 T.C. at 219

[347] *See, e.g.*, David M. Schizer, *Financial Instruments: Special Rules*, 186-2d TAX MGMT. PORT. (BNA), *at* Section IV.D (2024) ("Since the phrase 'financial asset' does not include debt instruments except under regulations, and no such regulations have been issued as of yet, this transaction should be outside the Code's scope. . . . Since 'financial assets' do not include common stock except under regulations, and no such regulations have been issued as of yet, [a dividend roll-up transaction with respect to common stock] is not reached by Code Sec. 1260.").

[348] *15 West 17th St. LLC*, 147 T.C. at 574 ("Although many discretionary delegations include the words 'may prescribe' or 'may be prescribed,' other verbal formulas exist. For example, Code Sec. 6042(b)(2), governing reporting by dividend payors, provides that 'dividends' do not include certain payments 'to the extent provided in regulations prescribed by the Secretary.'"). *But see Traylor v. Commissioner*, 59 T.C.M. (CCH) at 93. Note that the taxpayer in *Traylor* did not raise the "spurned delegation" issue.

entity" stock as a "financial asset," and thus subjecting it to the punitive rules of Code Sec. 1260, would not benefit any taxpayer. Finally, the legislative history sheds no light on what kind of regulations Congress envisioned under Code Sec. 1260(c)(1)(B). It is not surprising that the Tax Section of the New York Bar Association said that Code Sec. 1260 "would apply only through regulations to common stock of a corporation that is not a pass-thru entity and to debt."[349]

2. Code Sec. 1260(d)(1)(D)—"Substantially the Same Effect" Transactions

It is more likely that Code Sec. 1260 applies to transactions or positions that have "substantially the same effect" as the categories of COTs enumerated in Code Sec. 1260(d)(1)(A)–(C) in the absence of regulations under Code Sec. 1260(d)(1)(D). Although this is clearly not a taxpayer-friendly rule and—like Code Sec. 1260(c)(1)(B)—a "to the extent" delegation, courts have nevertheless sometimes treated such delegations as self-executing.[350]

Moreover, the legislative history of Code Sec. 1260 specifies relatively clearly what Congress envisioned:

> The Committee anticipates that Treasury regulations, when issued, will provide specific standards for determining when other types of financial transactions, like those specified in the provision, have substantially the same effect of replicating the economic benefits of direct ownership of a financial asset without a significant change in the risk-reward profile with respect to the underlying transaction.[351]

Finally, Code Sec. 1260(d)(1)(D) provides that the transactions to be covered by regulations are those that have "substantially the same effect" as the COTs in Code Sec. 1260(d)(1)(A)–(C). Accordingly, a court could look to *those* subparagraphs in attempting to fashion "phantom regulations" under Code Sec. 1260(d)(1)(D). For example, Code Sec. 1260(d)(3) defines a long position under an NPC as one with respect to which the taxpayer "has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on such financial asset for a specified period, and is obligated to reimburse (or provide credit for) all or substantially all of any decline in the value of such financial asset." This provides some guidance on the types of transactions that Congress intended for the Treasury to address with regulations promulgated under Code Sec. 1260(d)(1)(D).

Accordingly if a transaction is not within the enumerated list of COTs, but does not significantly "change the risk-reward profile" of the underlying reference asset(s) and otherwise resembles the COTs listed in Code Sec. 1260(d)(1)(A)–(C), many tax practitioners are concerned

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[349] N.Y. State Bar Ass'n, *Comments on Constructive Ownership and H.R. 1703* (July 8, 1999), at 4.

[350] *See Traylor v. Commissioner*, 59 T.C.M. (CCH) (1993) at 93.

[351] S. REP. NO. 106-120, at 203 (1999).

that a court would treat the transaction as covered by Sec. 1260(d)(1)(D), even in the absence of regulations.[352]

3. Code Sec. 1260(g)(2)—Non-"Substantially All" Forward Contracts

Finally, it is not clear whether—in the absence of regulations—Code Sec. 1260 excludes forward contracts that do not convey "substantially all" of the economic return of the relevant financial asset. Tax practitioners are divided. First, some believe that the provision *is* self-executing, because unlike the other two delegations under the statute, Code Sec. 1260(g)(2) provides that the "Secretary shall prescribe" regulations excluding such forward contracts and thus may be a "mandatory delegation."[353] Moreover, Code Sec. 1260(g)(2) is a taxpayer-friendly rule (it would exclude certain contracts from the punitive regime of Code Sec. 1260), which suggests that courts are more likely to treat it as self-executing. Finally, Code Sec. 1260(d)(1)(A) and (C) provide some guidance on the types of transactions that Congress clearly intended to be COTs, which may provide some guidance to courts in crafting "phantom regulations" under Code Sec. 1260(g)(2).[354] Others believe that Code Sec. 1260 applies to *all* forward contracts that constitute a "contract to acquire in the future (or provide or receive credit for the future value of) any financial asset" even if they do not provide substantially all of the return of the underlying asset.[355]

iii. Application to Structured Notes

Most structured note tax practitioners take the position that, until Treasury promulgates regulations under Code Sec. 1260(c)(1)(D), the Code Sec. 1260 regime should not apply to Debt Notes.

The market is less certain about the application of Code Sec. 1260 to Prepaid Derivative Notes. Depending on the willingness of courts to create "phantom regulations" under Code Sec. 1260, the statute may apply to Prepaid Derivative Notes in one of three ways: (i) Code Sec. 1260 might apply to Prepaid Derivative Notes that are "forward contracts"—*i.e.*, "contract[s] to acquire in the future (or provide or receive credit for the future value of) any financial asset," (ii) Code Sec. 1260 might apply in a more limited way to Prepaid Derivative Notes that are "forward

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[352] *But see* Schizer, *supra* 347, at IV.E (discussing Code Sec. 1260(d)(1)(D) in terms of what regulations may ultimately provide, implying the provision is not self-executing in the absence of such regulations).

[353] *See, e.g.*, Hochberg, *supra* note 338, at ("Unlike the regulatory delegations . . . that are discussed elsewhere in this paper, this delegation states that the Secretary 'shall' issue Regulations. This is the type of delegation that . . . the courts have viewed as 'how' regulations that are often self-executing in the absence of regulations.").

[354] The IRS has issued guidance in other contexts that defines "substantially all." *See, e.g.*, Treas. Reg. § 1.731-2(c)(3)(i) (90% threshold for determining whether "substantially all" of an entity's assets consist of marketable securities or cash); Treas. Reg. § 1.448-1T(e)(4) (95% threshold in determining whether personal services constitute "substantially all" of a corporation's activities); Rev. Proc. 77-37, 1977-2 C.B. 568 (70% of gross assets and 90% of net assets are "substantially all" for purposes of the reorganization provisions).

[355] *See, e.g.*, Schizer, *supra* note 347, at IV.D.5 ("As originally proposed, the forward contract definition would not apply to [a forward with economics like a call option that provides for only upside but not downside], since the amount of property is not 'substantially fixed.' But as enacted, §1260(d)(4) should be broad enough to cover this transaction, such that §1260 should apply.").

contracts" that convey "substantially all" of the economic return of the relevant financial asset, and/or (iii) Code Sec. 1260 might apply to Prepaid Derivative Notes that have "substantially the same effect" as the categories of COTs enumerated in Code Sec. 1260(d)(1)(A)–(C).

Because of this uncertainty, most disclosure for Prepaid Derivative Notes includes a caveat that the issuer's tax advisor is unable to opine whether Code Sec. 1260 could apply. Nevertheless, under the view that Code Sec. 1260(g)(2) might be self-executing, some structured note tax practitioners include more extensive disclosure regarding the risk of Code Sec. 1260 applying to a Prepaid Derivative Note when they believe it conveys "substantially all" of the economics of the Reference Asset. How do practitioners apply the "substantially all" test in this context? Some tax practitioners apply a "delta" test. Generally, delta is the ratio of the change in the fair market value of a derivative to a small change in the fair market value of the number of shares of the underlying security.[356] If the delta of the Prepaid Derivative Note is higher than some threshold, these practitioners will include "enhanced" Code Sec. 1260 disclosure, disclosing the risk that Code Sec. 1260 could apply with more acuity than their "base" Code Sec. 1260 disclosure. Delta thresholds vary among practitioners, but thresholds between 66.67% and 80% are common.

As noted above, to the extent that gain from a COT is treated as a long-term capital gain even after the applying the ordinary income recharacterization rule,[357] the capital gain rates applicable to the gain are determined based on the rates that would have applied to the NULTCG. Accordingly, if a Prepaid Derivative Note is linked to "collectibles," as defined in Code Sec. 408(m), there is a risk that Code Sec. 1260 could cause a portion of the long-term capital gain with respect to the Prepaid Derivative Note to be taxed at 28%.[358] This could arise, for example, if a Prepaid Derivative Note is linked to the shares of an exchange-traded fund that is treated as a grantor trust and holds collectibles (such as gold, silver, or uranium).

f. PFIC Rules

i. Overview

Very generally, the PFIC rules are intended to prevent "United States persons" (as defined for U.S. federal income tax purposes) from deferring U.S. federal income tax on passive income earned through non-controlled foreign corporations and converting ordinary income into capital gains.[359]

The potential application of the PFIC rules to structured notes is extremely complex. Under Code Sec. 1298(a)(4), "to the extent provided in regulations, if any person has an option to acquire stock, such stock shall be considered as owned by such person." Treasury regulations proposed in 1992, which—if finalized—would be effective on April 1, 1992, provide that "if a U.S. person has an option to acquire stock of a PFIC . . . such option is considered to be stock of a PFIC for purposes

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[356] *See* Treas. Reg. § 1.871-15(g)(1) (defining delta for purposes of calculating dividend equivalents).

[357] *See* Code Sec. 1260(a)(1).

[358] *See generally* Code Sec. 1(h)(5).

[359] *See generally* Code Secs. 1291–1298.

of applying Section 1291 and these regulations to a disposition of the option."[360] Moreover, under the proposed regulation "an option to acquire an option, and each one of a series of such options, are considered an option to acquire stock."[361] Here, we confront two great mysteries: (i) whether Code Sec. 1298(a)(4) is self-executing in the absence of *final* regulations and (ii) whether and when a structured note might be treated as (or treated as containing) an "option" for purposes of Code Sec. 1298(a)(4).

At the outset it is important to note that the proposed regulations under Code Sec. 1298 carry little authoritative weight. In general, even before *Loper Bright Enterprises v. Raimondo*,[362] courts have viewed proposed regulations as carrying no more weight than a position advanced in a brief—*i.e.*, they are merely options for consideration presented for public comment that are not entitled to deference.[363]

With respect to the "spurned delegation" question, at least some practitioners believe that Code Sec. 1298(a)(4) is *not* self-executing.[364] First, Code Sec. 1298(a)(4) is not a taxpayer-friendly rule. Second, the legislative history sheds little light on how Congress intended for Code Sec. 1298(a)(4) to apply, saying only that "[t]he committee anticipates that regulations will provide this treatment where necessary to prevent avoidance of the imposition of interest."[365] This suggests that Congress intended for Code Sec. 1298(a)(4) to serve as an anti-abuse rule, but it provides no guidance on the contours of the rule that Congress envisioned. Finally, and most importantly, Code Sec. 1298(a)(4) appears to be a "policy delegation," which courts ordinarily treat as non–self-executing, because it states that the PFIC rules will apply to options "to the extent provided in regulations."[366] New York City Bar Association Committee on Taxation of Business Entities has said the following:

> [T]here is a question as to whether the option attribution rule of Code Sec. 1298(a)(4) applies in the absence of final or temporary regulations. We do not comment on this issue

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[360] Prop. Reg. § 1.1291-1(d). The final regulations provide that a "qualified electing fund" election, which ameliorates the punitive impact of the PFIC rules in the case of a PFIC shareholder, is not available to the holder of an option. *See* Treas. Reg. § 1.1295-1(b)(2)(iii); Treas. Reg. § 1.1291-1(d)(5).

[361] Prop. Reg. § 1.1291-1(d). However, the proposed regulations provide that the exercise of an option is not treated as a disposition to which Code Sec. 1291 applies. *See id.*

[362] 603 U.S. 369 (2024). This case overruled *Chevron USA, Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), and held that judicial deference to agency interpretations of federal statutes conflicts with the foundational understanding of the judicial role as codified in the Administrative Procedure Act.

[363] *See, e.g.*, *Tedori v. United States*, 211 F.3d 488, 492 (9th Cir. 2000); *LeCroy Research Systems Corp. v. Commissioner*, 751 F.2d 123, 127 (2d Cir. 1984); *Teweleit v. Hartford Life & Accident Ins. Co.*, 43 F.3d 1005, 1019–1010 (5th Cir. 1995); *General Dynamics Corp. v. Commissioner*, 108 T.C. 107, 120 (1997); *United States v. Elton*, 97 AFTR2d 2361, n. 6 (E.D.N.Y. 2006); *Yokum v. United* States, 66 Fed. Cl. 579, 590 (2005); *McNamee v. Dep't of Treasury*, 488 F.3d 100, 109 (2d Cir. 2007).

[364] *See* Hochberg *supra* 338, at 22–23.

[365] H.R. REP. NO. 100-795, at 279 (1988).

[366] *See supra* note 348 and accompanying text.

other than to recommend that the Treasury Department issue such regulations as it deems appropriate to resolve the issue on a going-forward basis.[367]

Nevertheless, it is possible that, after the passage of 30 years, the Treasury could finalize the proposed regulations with a retroactive effective date. Thus, we must turn to the next question: whether a Prepaid Derivative Note might be treated as an "option" for purposes of Code Sec. 1298(a)(4). The definition of "option" for U.S. federal income tax purposes is not entirely clear.[368] Generally, "an option is a legal contract under which the grantor undertakes an obligation to sell to the holder of the option, or to purchase from the holder, specific property at a fixed or determinable price and time."[369] Further, it is not clear whether a contingent option is an "option" for U.S. federal income tax purposes.[370] Moreover, there are many other circumstances in which it is unclear whether a financial instrument is an "option" for U.S. federal income tax purposes.[371]

There is good reason to believe that most structured notes should not be "options" for purposes of Code Sec. 1298(a)(4). Although the economic profile of many structured notes includes an embedded option or options, most structured notes are not options under the simple definition above. (Although the market position is to bifurcate RevCons into an option and a deposit, the holder of the RevCon is the writer of the option and should not be subject to Code Sec. 1298(a)(4), because the holder has the option to sell, not the option to acquire.) Structured notes are *prepaid* financial instruments without an explicit option premium. Moreover, although they may contain an embedded option like many other structured notes, Debt Notes are principal-protected. Finally, most Prepaid Derivative Notes, to the extent they contain an embedded option, generally have a "knock-in" or "knock-out" feature, whereby the option is effective only once the value of the Reference Asset is above or below a certain trigger value. Accordingly, such embedded options are contingent, and it is not clear whether contingent options are "options" for U.S. federal income tax purposes.[372]

On the other hand, the proposed regulations are quite broad. Among other things, they apply to an "option to acquire an option" to acquire PFIC stock.[373] Similarly, in illustrating the rule that holding period of a share of stock of a PFIC acquired upon the exercise of an option includes

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[367] N.Y.C. Bar, Comm. on Tax'n of Bus. Entities, *Report Offering Proposed Guidance Regarding the Passive Foreign Investment Company Rules* (Sept. 21, 2009), at 69.

[368] *See* Matthew A. Stevens, *The Tax Treatment of Contingent Options*, 102 TAX NOTES 535 (2004); Kevin J. Liss, *The Option Conundrum in Tax Law: After All These Years, What Exactly is an Option*, 63 TAX LAW. 307 (2010).

[369] Keyes, *supra* note 97, at ¶ 12.02[1]. *See also* Rev. Rul. 78-182, 1978-1 C.B. 265, 267 (describing various types of options).

[370] *See generally* Stevens *supra* note 368. *See, e.g.*, Rev. Rul. 68-601, 1968-2 C.B. 124 (ruling that an option was not an option to acquire stock for purposes of the Code Sec. 318 when contingencies existed).

[371] *See generally* Liss *supra* note 368.

[372] *See* Stevens *supra* note 368.

[373] Prop. Reg. § 1.1291-1(d).

the period the option was held,[374] the proposed regulations contain an example that appears to extend the option rule to convertible debt:

> On January 1, 1993, X issues a debt instrument to G, a U.S. person. Under the terms of the instrument, G may convert the debt instrument into 20 shares of the stock of Y on any date prior to the maturity date of December 31, 2002. On August 14, 1997, G exercises the conversion right and receives 20 shares of Y stock. Pursuant to Prop. Reg. § 1.1291-1(h)(3), G's holding period of the Y stock begins at the time of the acquisition of the debt instrument, not at the time of acquisition of the Y stock.

Accordingly, the leading treatise on PFICs states that "it is unclear whether the option rule extends to convertible debt issued by a foreign corporation that is or was a PFIC during all or a portion of the taxpayer's holding period for the debt."[375] Other commentators are more direct, citing the example as support for the proposition that "these rules apply not only to direct stock options, but also to options that arise under the conversion feature of a debt instrument issued by a foreign corporation that is a PFIC."[376] Since the option rule may apply to convertible debt, there is at least some concern that it would apply to other financial instruments with embedded option economics, like certain Prepaid Derivative Notes.

ii. Market Practice

Notwithstanding that (i) Code Sec. 1298(a)(4) may not be self-executing and (ii) there are good reasons to believe most structured notes are not options, structured notes tax practitioners exercise caution in this area. This seems reasonable in light of the breadth of the proposed regulations the fact that the proposed regulations take the position that Code Sec. 1298(a)(4) applies to convertible debt. As a result, offering materials for many structured notes contain tax disclosure providing that the issuer and its counsel will not attempt to determine whether any Reference Asset is a PFIC, and that adverse tax consequences could apply to U.S. Holders if it is.

g. FIRPTA

This section of the paper discusses the extent to which the "FIRPTA" rules of Code Sec. 897 and Code Sec. 1445 could apply to a structured note. Under FIRPTA, gain or loss of a non-"United States person" (as defined for U.S. federal income tax purposes) that disposes of a "U.S. real property interest" (a "USRPI") generally is treated as if it were income effectively connected with a trade or business within the United States ("ECI").[377] ECI is generally subject to U.S.

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[374] *See* Prop. Reg. § 1.1291-1(h)(3).

[375] Devon M. Bodoh, *PFICs*, 6300-1st TAX MGMT. PORT. (BNA), at IV.E.1 (2025).

[376] Edward K. Dennehy et al., *A Primer on PFIC Taxation*, TAX NOTES INT'L, at 192 (Jan 11, 2010).

[377] *See generally* Code Sec. 897(a)(1). In addition, under Code Sec. 1445, the "transferee" of a USRPI generally is required to withhold tax in an amount equal to 15% of the amount realized on the disposition. This withholding tax is creditable against the U.S. income tax liability of the transferor. The Code defines "transferee" for this purpose as "the person acquiring the United States real property interest." *See* Code Sec. 1445(f)(2). *See also* Treas. Reg. § 1.1445-1(g)(4) ("The term 'transferee' means any person, foreign or domestic, that acquires a U.S. real property interest by purchase, exchange, gift, or any other transfer.").

taxation on a net basis and at graduated tax rates and subject to U.S. withholding.[378] Accordingly, if a structured note were treated as a USRPI, Non-U.S. Holders would be required to file a U.S. income tax return, pay U.S. federal income tax, and could be subject to 15% withholding tax on any disposition of the structured note.[379]

i. Overview of Relevant FIRPTA Rules

1. Definition of USRPI

A USRPI generally includes both (i) a "right (whether or not presently exercisable) directly or indirectly to acquire, by purchase, conversion, exchange, or in any other manner," an interest in a corporation, partnership, or trust; and (ii) an "interest which is, in whole or in part, a direct or indirect right to share in the appreciation in value" of an interest in a corporation, partnership, or trust or a "direct or indirect right to share in the appreciation in value of assets of, or gross or net proceeds or profits derived by," the corporation, partnership, or trust (the "Right to Share Rule").[380]

Read alone, this may seem quite expansive. However, the Treasury Regulations clarify that the Right to Share Rule includes within its ambit "any right to a payment *from an entity* the amount of which is contingent on the appreciation in value" of an equity interest in a corporation, partnership, or trust "or which is contingent on the appreciation in value of assets of, or the general gross or net proceeds or profits derived by, such entity."[381] Additionally, while USRPIs include "any interest (other than an interest solely as a creditor) in any domestic corporation," the definition excludes any such interest if the taxpayer establishes that the corporation was not a United States real property holding corporation (a "USRPHC") at any time during a specified period.[382] The taxpayer generally can also satisfy this requirement by obtaining a statement from the corporation or getting a determination by the IRS.[383]

In addition to the limitations discussed above, the IRS has issued one revenue ruling concerning the potential application of FIRPTA to derivatives. In Rev. Rul. 2008-31,[384] the IRS ruled that a swap with a return linked to an index referencing data from a geographically and numerically broad range of U.S. real estate assets was not treated as a USRPI, because of the broad-based nature of the index. The ruling noted that the "short" party on the swap did not "directly or

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[378] Code Sec. 871(b); 882.

[379] Code Sec. 1445(f)(2).

[380] *See* Treas. Reg. § 1.897-1(d)(3)(i).

[381] *See* Treas. Reg. § 1.897-1(d)(3)(ii)(B) (emphasis added).

[382] *See* Code Sec. 897(c)(1)(A)(ii). The specified period is the during the shorter of (i) the period after June 18, 1980, during which the taxpayer held such interest or (ii) the five-year period ending on the date of the disposition of such interest. *See id*. An interest in publicly-traded partnership (a "PTP") is treated as an interest in a corporation for purposes of determining whether the interest is a USRPI, including for purposes of determining whether the PTP is a USRPHC. *See* Treas. Reg. § 1.897-1(c)(2)(iv).

[383] *See* Treas. Reg. § 1.897-2(g).

[384] 2008-1 C.B. 1180.

indirectly, own or lease a material percentage of the real property, the values of which are reflected by the [i]ndex."[385]

2. Regularly Traded Interest Exception

Under the "Regularly Traded Interest Exception," if any class of stock issued by a corporation is "regularly traded on an established securities market," stock in that class generally is a USRPI only in the hands of a taxpayer who beneficially owned more than 5% (10% in the case of REITs)[386] of the total FMV of that class of interests during a five-year lookback period.[387] The term "established securities market" means (i) a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934,[388] (ii) a foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority, and (iii) any over-the-counter market.[389]

Structured notes, other than ETNs, are generally not listed on a domestic or foreign exchange. However, an "established securities market" also includes "any over-the-counter market."[390] The regulations define an over-the-counter market as the following:

> [A]ny market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.[391]

Generally, a "class of interests that is traded on one or more established securities markets is considered to be regularly traded on such market or markets for any calendar quarter during which . . . [t]rades in such class are effected, other than in de minimis quantities, on at least 15 days during the calendar quarter; [and] . . . [t]he aggregate number of the interests in such class traded is at least 7.5% or more of the average number of interests in such class outstanding during the calendar quarter."[392] In addition, a class of interests that is traded on an established securities

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[385] *Id.*

[386] *See* Code Sec. 897(k)(1).

[387] *See* Code Sec. 897(c)(3); Treas. Reg. § 1.897-1(c)(2)(iii)(A). The five-year lookback period generally is the five-year period ending either on the date of disposition of the interest or other applicable determination date. *See id.*

[388] 15 U.S.C. 78f.

[389] *See* Treas. Reg. § 1.897-1(m).

[390] *See* Treas. Reg. § 1.897-1(m)(3).

[391] *Id.*

[392] Treas. Reg. § 1.897-9T(d)(1)(i). Under Treas. Reg. § 1.897-9T(d)(1)(ii)–(iii), special exceptions and an anti-abuse rule may apply. In addition, for a class of interests to qualify as "regularly traded," the corporation must register the class of interests pursuant to section 12 of the Securities Exchange Act of 1934, 15 U.S.C. 78, or attach to its U.S.

market located *in the United States* is considered to be regularly traded for any calendar quarter during which it is regularly quoted by brokers or dealers making a market in such interests—*i.e.*, the brokers or dealers holds themselves out to buy or sell interests in such class at the quoted price.[393]

3. Non-Traded Interest Exception

Under the "Non-Traded Interest Exception," a non-regularly traded class of interests in a corporation that has at least one class of regularly-traded interests generally is treated as a USRPI only if on the date the interest is acquired, the interest has a FMV greater than that of 5% of the class of the corporation's regularly traded interests with the lowest FMV.[394] If a person holds a non-regularly traded class of interests in a corporation and subsequently acquires additional interests of the same class, then all such interests must be aggregated and valued as of the date of the subsequent acquisition.[395] In addition, under the "Aggregation Rule," if a person holds interests in a corporation of separate classes that are not regularly traded, and if such interests were separately acquired for a principal purpose of avoiding the 5% FMV limitation, then such interests are aggregated for purposes of applying that limitation.[396]

Moreover, if a non-regularly traded class of interests in the corporation is convertible into a regularly traded class of interests in the corporation, an interest in such non-regularly traded class is treated as a USRPI if on the date it was acquired it had an FMV greater than that of 5% of the regularly traded class of the corporation's stock into which it is convertible.[397]

ii. Application to Structured Notes that Do Not Provide for Physical Settlement

In light of Code Sec. 897(c)(1)(A)(ii), which presumes that an interest other than solely as a creditor in *any* domestic corporation is treated as a USRPI unless the taxpayer establishes otherwise, the question arises whether structured notes that provide for upside based on the appreciation in the value of any Reference Asset consisting of the shares of a domestic corporation

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federal income tax return a statement containing certain information. *See* Treas. Reg. § 1.897-9T(d)(1)(i); Treas. Reg. § 1.897-9T(d)(3).

[393] *See* Treas. Reg. § 1.897-9T(d)(2).

[394] *See* Treas. Reg. § 1.897-9T(b). *See also* Treas. Reg. § 1.897-1(c)(2)(iii)(B).

[395] *See* Treas. Reg. § 1.897-9T(b). If the subsequent acquisition causes that person's interests to exceed the applicable limitation, then all such interests are treated as USRPIs, regardless of when acquired. *See id.*

[396] *See id.* This rule does not apply to interests of separate classes acquired in transactions more than three years apart. *See id.*

[397] *See id.*

(including as part of an index or basket of Reference Assets) are subject to FIRPTA.[398] However, as discussed further below, the application of FIRPTA to derivatives is far from clear.[399]

1. Limited to Interests *Directly* in the Issuer?

One could argue that Code Sec. 897 and 1445 should not apply to derivative financial instruments like structured notes, because those Code sections and the Treasury Regulations thereunder apply only to financial instruments that are issued by, and enforceable against, the underlying corporation or partnership. The clarifying language in Treas. Reg. § 1.897-1(d)(3)(ii)(B) suggests that the Right to Share Rule is intended to apply only to contractual payment rights that are issued by, and enforceable against, the underlying issuer. That provision refers to "any right to a payment from an entity." In the case of structured notes, Non-U.S. Holders do not have any right to payment from the issuer of the relevant Reference Assets.

Moreover, in setting forth the Regularly Traded Interest Exception, the Treasury Regulations appear to contemplate Code Secs. 897 and 1445 as applying only to direct interests in an entity and not to transactions to which the entity is not a party, such as structured notes. The relevant provisions refer to a "class of interests in the corporation" and "interests in a corporation of separate classes." Arguably, structured notes are not interests "in" any issuer of a Reference Asset. Moreover, derivative financial instruments like structured notes, unlike interests issued by an entity, generally do not consist of "classes." Finally, because the issuer of the structured notes is not compelled to hedge the notes in any particular manner, it may not necessarily own the underlying Reference Assets. Accordingly, it is hard to see how the issuer could be "sharing" in appreciation or profits from the Reference Assets with Non-U.S. Holders through the structured notes.

Nevertheless, Rev. Rul. 2008-31 can be read to suggest that the FIRPTA rules do apply to derivative financial instruments. First, the ruling concludes that the swap at issue was not a USRPI because it was linked to a "broad-based" index. This could imply that derivatives linked to narrower exposures (such as a single stock or a basket of stocks) could be USRPIs. Second, the ruling takes pains to point out that the short party on the swap did not hedge with the reference assets. In the case of structured notes, although issuers can (and do) hedge in multiple ways, issuers generally *will* acquire an interest (in many cases, a derivative interest) in the Reference Asset in some form. Accordingly, one might be concerned that the swap at issue in ruling is distinguishable from typical structured notes.[400]

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[398] Similar issues could arise for structured notes that reference interests in PTPs. For simplicity, this paper focuses on structured notes linked to the performance of one or more domestic corporations.

[399] By far, the best resource on the topic is Lorenz F. Haselberger & Michael B. Shulman, *Holding Nothing Back: Everything We Know About Withholding on Derivatives*, 183 TAX NOTES FED. 801 (2024).

[400] This might present challenging diligence issues to an advisors of a structured notes issuer, because the advisors generally will not know how the issuer will hedge.

2. Application of the Regularly Traded Interest Exception

Can structured notes qualify for the Regularly Traded Interest Exception? As noted above, structured notes, other than exchange-traded notes ("ETNs"), are generally not listed on a domestic or foreign exchange. Are structured notes treated on an "over-the-counter market," as defined in Treas. Reg. § 1.897-1(m)(3)?

In the author's experience, although structured notes issuers issue their notes with the expectation that they may be sold by to other banks on a secondary market, and dealers generally do not publish quotations for these structured notes. Structured note holders generally sell their notes by contacting a bank and requesting a quote. Accordingly, as a general matter, it appears unlikely that structured notes would be treated as listed on an "over-the-counter" market, and thus it is unlikely that they qualify for the Regularly Traded Exception. However, exceptions may exist, and markets may evolve in the future.

3. Application of the Non-Traded Interest Exception

If a structured note were treated as a potential USRPI but not treated as regularly traded on an established securities market, it would be considered a "non-regularly traded class of interests" and tested for eligibility for the Non-Traded Interest Exception.

As a practical matter, it is unlikely that any given structured note, at the time of issue, would have an FMV greater than that of 5% of the class of the Reference Asset issuer's regularly traded interests with the lowest FMV. An issuer of structured notes generally would have difficulty hedging exposure of that size. As a result, it is likely that most structured notes—even if they were treated as potential USRPIs—would be able to qualify for the Non-Traded Interest exception.[401]

4. Application of the "Convertible Interest" Rule

As noted above, if a non-regularly traded class of interests in the corporation is convertible into a regularly traded class of interests in the corporation, an interest in such non-regularly traded class is treated as a USRPI if on the date it was acquired it had an FMV greater than that of 5% of the regularly traded class of the corporation's stock into which it is convertible.[402] Could this rule apply to structured notes that provide only for cash settlement? In other words, could the cash settlement of a structured note linked to a publicly-traded corporation's equities be treated as "convertible" into that issuer's publicly traded shares (with the conversion being mandatorily cash-settled)? Even if one were to interpret the "convertible interest" rule in this fashion, as noted above, in the case of most structured notes, it is unlikely

[401] However, Non-U.S. Holders should be mindful of the Aggregation Rule discussed above if they acquire the structured note alongside *other* potential USRPI exposure to the same domestic corporation with a principal purpose of qualifying for the Non-Traded Interest Exception. *See supra* note 396 and accompanying text.

[402] *See* Treas. Reg. § 1.897-9T(b).

that that the structured note, at issuance, would have an FMV greater than that of 5% of the class of the regularly traded interests to which it is linked.

iii. Application to Structured Notes That Provide for Physical Settlement

If a structured note that provides for (i) upside with respect to the appreciation of a Reference Asset consisting of the stock of a domestic corporation *and* (ii) physical settlement, it is possible that the note would be treated as a USRPI because it is "right (whether or not presently exercisable) directly or indirectly to acquire, by purchase, conversion, exchange, or in any other manner" shares in the domestic corporation.[403] Moreover, it is more likely that the "convertible interest" rule discussed above might apply to a physically settled note than a note that provides for cash settlement,[404] although the application of that rule would depend on whether the structured note had an FMV greater than that of 5% of the regularly traded class of the corporation's stock into which it is convertible. Accordingly, it is possible that the Non-U.S. Holder would be subject to FIRPTA unless it establishes that the structured note qualifies for the Regularly Traded Interest Exception (which, as discussed above, is unlikely) or the Non-Traded Interest Exception (which, as discussed above, is more likely).

iv. Market Practice

Because of the uncertainty surrounding the potential application of FIRPTA to structured notes (and derivatives in general), most issuers and structured note tax practitioners generally disclose that they will not attempt to determine whether (i) the issuer of any Reference Asset could be treated as a USRPHC or (ii) the structured note could be treated as a USRPI, and adverse consequences could apply to Non-U.S. Holders if either of the foregoing is true.

h. Deemed Exchanges

i. Introduction

Most structured notes provide for adjustments to the terms of the note if certain events occur with respect to the Reference Asset. For example, if the Reference Asset is an index that undergoes a rebalance event that changes its composition, the structured note will generally reference the rebalanced index. Similarly, if a Reference Asset consists of the shares of a corporation and that corporation undergoes a spin-off or merger, the terms of the structured note may be adjusted to account for the corporate event. Sometimes, these changes will occur automatically (*e.g.*, when an index is rebalanced) or will occur as a result of a determination made by a calculation agent, usually the issuer or an affiliate of the issuer.

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[403] Treas. Reg. § 1. 897-1(d)(3)(i)(E).

[404] *See* Treas. Reg. § 1.897-9T(b) ("[I]f a non-regularly traded class of interests in the corporation is convertible into a regularly traded class of interests in the corporation, an interest in such non-regularly traded class shall be treated as a U.S. real property interest if on the date it was acquired by its present holder it had a fair market value greater than the fair market value on that date of 5 percent of the regularly traded class of the corporation's stock into which it is convertible.").

ii. Analysis & Market Practice

There is a large body of tax commentary on when a change to the terms of a derivative results in a deemed exchange under Code Sec. 1001 of the original derivative for a new derivative.[405] In general, the broad consensus among structured note tax practitioners is an *automatic* change in the composition of a Reference Asset consisting of an index or basket should not give rise to a taxable event under Code Sec. 1001 for the contract holder, because either (i) the Reference Asset is an index based on objective financial information not within the control of the issuer or the holder of the structured note or (ii) changes to the composition of the Reference Asset occur pursuant to the terms of the structured note.

When there is a discretionary change to the assets as a result of an exercise of the calculation agent's discretion, the analysis is more challenging. However, at least some structured note tax practitioners believe that such changes should not result in a Code Sec. 1001 event if (i) the change preserves the noteholders' exposure to the economics of the original reference asset (*e.g.*, if the calculation agent determines that the note should reference both the spun-off company and the distributing company after a spin-off) or (ii) the change is "functionally" automatic (although it is discretionary in form).[406]

Nevertheless, because the law is not entirely clear and because it is impossible to predict the nature of every possible change to the terms of a note, most issuers and advisors include tax disclosure along the following lines:

> It is possible that an adjustment to the terms of the notes and/or the Reference Asset in respect of events that occur with respect to the Reference Asset could result in a taxable event with respect to the notes for U.S. federal income tax purposes. This could cause you to recognize taxable gain or loss (subject to the possible application of the wash sale rules[407]) and could affect your holding period for the notes. Moreover, after the taxable event, the notes could be treated for U.S. federal income tax purposes in a manner that differs from their original treatment, which could materially and adversely affect the timing and character of items of income, gain, loss, or deduction in respect of the notes. You should consult with your tax advisor regarding this risk.

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[405] *See, e.g.*, Michael Shulman & Nate Tasso, *Changes to Derivatives "Pursuant to Their Terms" (Part 1)*, 155 TAX NOTES 653 (2017); Michael Shulman & Nate Tasso, *Changes to Derivatives "Pursuant to Their Terms" (Part 2)*, 155 TAX NOTES 805 (2017) [hereinafter Changes Part 2]; James S. Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 95 TAX NOTES 737 (2002).

[406] *See* Changes Part 2 *supra* note 405, at 818.

[407] *See* Code Sec. 1091 (generally limiting a taxpayer's ability to sell depreciated securities, deduct the loss, and then, within a specified period of time, acquire or enter into a contract or option to acquire substantially identical securities).

i. The Basket Contract Regulations

i. Overview

In addition to presenting the risk of a deemed exchange, a change in the Reference Assets of a structured note during its term could, in certain circumstances, cause the structured note to be a reportable transaction. Briefly, the reportable transaction rules are a regime that requires taxpayers and "material advisors" to report to the IRS transactions that the IRS views as tax avoidance transactions or potential tax avoidance transactions.[408]

Under regulations proposed in 2024, if a contract references a basket of assets and the composition of those assets changes during the term of the derivative, tax practitioners must consider the potential application of Prop. Treas. Reg. § 1.6011-16 (the "Basket Contract Regulations").[409] The Basket Contract Regulations target strategies pursuant to which taxpayers "wrap" a trading strategy in a derivative to defer taxation and treat ordinary income and short-term capital gain as long-term capital gain. The recent tax case *GWA v. Commissioner*[410] illustrates the archetypical transaction targeted by the Basket Contract Regulations. In *GWA*, a hedge fund entered into a multi-year contract denominated as a barrier option with an investment bank. The barrier option reflected the performance a trading portfolio, which the investment bank held on its books to hedge its exposure with respect to the barrier option. If the hedge fund owned the trading portfolio, it would have recognized short-term capital gain and ordinary income in each taxable year. However, the hedge fund took the position that it was the long party on a multi-year derivative, which gave rise to a long-term capital gain only in the taxable year that the barrier option was terminated.[411] The Tax Court held that, for U.S. federal income tax purposes, the barrier option was not a true option and that the hedge fund, in substance, was the owner of the trading portfolio.[412]

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[408] *See* Treas. Reg. § 1.6011-4; Treas. Reg. § 301.6111-3. For a great overview of these rules, see Linda Z. Swartz & Jean M. Bertrand, *To Disclose or Not to Disclose: Tax Shelters, Penalties, and Circular 230 in 2018*, *in* THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS (PLI 2020, supp. 2025).

[409] This set of reportable transaction rules has actually undergone three iterations: an initial set of IRS notices, a second set of IRS notices that superseded the first, and finally the proposed regulations. First, the IRS designated certain basket contracts as reportable transactions in 2015 by issuing Notice 2015-47, 2015-30 I.R.B. 76 and Notice 2015-48, 2015-30 I.R.B. 77. Next, these initial notices were—in relatively short order—superseded by Notice 2015-73, 2015-46 I.R.B. 660 and Notice 2015-74, 2015-46 I.R.B. 663, respectively. Finally, Prop. Treas. Reg. § 1.6011-16, published in 2024, obsoleted Notice 2015-74, 2015-46 I.R.B. 663. After the publication of the Prop. Treas. Reg. § 1.6011-16, the IRS announced that it would follow certain court decisions, which held that reportable transactions designated by notices failed to comply with the Administrative Procedure Act, and will no longer defend certain post-2024 reportable transaction notices, including Notice 2015-73, 2015-46 I.R.B. 660. *See* Action on Decision 2024-1, I.R.B. No. 2024-52 (Dec. 23, 2024) (citing *Green Rock LLC v. I.R.S.*, 104 F.4th 220 (11th Cir. 2024) and *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022)).

[410] T.C. Memo. 2025-34 (Apr. 16, 2025).

[411] *See* Section 1234A.

[412] For a super discussion of the *GWA* case see Joe Pahl & Rebecca E. Lee, *When an "Option" Isn't: Unwinding MAPS in GWA v. Commissioner*, 22 J. TAX'N FIN. PRODS. (2025).

Although they nominally target what the IRS perceives to be abusive transactions, the Basket Contract Regulations are drafted quite broadly and many commentators have noted that they may apply to non-abusive or non–tax-motivated transactions.[413]

Very generally, under Prop. Treas. Reg. § 1.6011-16, a taxpayer is treated as participating in a listed transaction if (i) the taxpayer enters into a contract to receive a return based on the performance of a reference basket of assets (which could include an index); (ii) the taxpayer or its "designee"[414] exercises "discretion" to change the composition of the assets in the reference basket; and (iii) the taxpayer's tax return reflects a "tax benefit"[415] from the transaction.[416]

A full description of the Basket Contract Regulations is beyond the scope of this paper.[417] The remainder of the discussion in this Part III.i will focus on the aspects of the Basket Contract Regulations that are most relevant to structured notes.

For example, assume a three-year Prepaid Derivative Note references a basket of Reference Assets; the basket consists of publicly-traded equity securities that the issuer's research analysts believe will outperform the broader equities market. Each month, the issuer of the Prepaid Derivative Note will rebalance the basket by changing its composition to reflect its research analysts' most recent stock picks. The holder of the Prepaid Derivative Note takes the position that the rebalancing event does not give rise to a deemed exchange under Code Sec. 1001.[418] Accordingly, the holder takes the position that it does not recognize any gain with respect to the Prepaid Derivative Note until maturity and any gain recognized at maturity is long-term capital gain. There is a significant risk that this Prepaid Derivative Note is a listed transaction, because it is likely that the IRS would assert that (i) the issuer of the Prepaid Derivative Note is the holder's

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[413] *See, e.g.*, SIFMA, *2024 Proposed Regulations for the Identification of Basket Contract Transactions as Listed Transactions* (Sept. 10, 2024) ("The overbreadth of the proposed regulations could create significant disruption in the market for non-tax motivated derivative transactions."); N.Y. State Bar Ass'n, *Report on Proposed Regulations Identifying Basket Contract Transactions as Listed Transactions* (Sept. 10, 2024) (noting that the proposed regulations "could have the effect of significantly curtailing portions of the market for financial contracts linked to indices or rules-based baskets, which do not result in impermissible tax benefits under current law and are not tax avoidance transactions").

[414] "Designee" is defined broadly to mean a person who is (i) the taxpayer's agent under principles of agency law; (ii) compensated by the taxpayer for suggesting, requesting, or determining changes in the assets in the reference basket; or (iii) "selected" by the taxpayer to suggest, request, or determine changes in the assets in the reference basket or the trading algorithm. *See* Treas. Reg. § 1.6011-16(b)(3). Many financial products tax practitioners are troubled by the ambiguity of what it means for a person to be "selected" by the taxpayer, and the possibility that the term could be interpreted broadly to include parties with very attenuated connections to the taxpayer, such as index providers and other parties who may have now knowledge of the taxpayer or the contract that references the relevant index or basket.

[415] For these purposes, a "tax benefit" means "a deferral of income into a later taxable year or a conversion of ordinary income or short-term capital gain or loss into long-term capital gain or loss." Treas. Reg. § 1.6011-16(b)(5).

[416] *See generally* Treas. Reg. § 1.6011-16. This is only a high-level summary of the Basket Contract Regulations, which contain numerous sub-rules and exceptions that are not discussed in this paper.

[417] For a terrific discussion of the Basket Contract Regulations, see Brennan W. Young & Remmelt A. Reigersman, *Index Derivatives and Current "Basket Option" Guidance*, 21 J. TAX'N FIN. PRODS. 44 (2024).

[418] In light of the discussion *supra* in Part III.h, this position may be difficult to sustain on the merits.

designee because, among other things, it was selected by the holder to determine changers in the reference basket, (ii) the issuer has exercised discretion to change the composition of the reference basket, and (iii) the holder's tax return reflects a "tax benefit" within the meaning of Prop. Treas. Reg. § 1.6011-16(b)(5).

ii. Exception for "Algorithmic" Changes

Critically, a taxpayer (or its "designee") will not be treated as having exercised "discretion"—and thus the taxpayer will not be treated as having participated in a reportable transaction—if changes in the assets in the reference basket or the trading algorithm are made according to objective instructions, operations, or calculations that are disclosed at the inception of the transaction (collectively, the "Contract Rules") and the taxpayer (or its "designee") does not have the right to alter or amend the Contract Rules.[419] Many structured notes that are linked to a basket of Reference Assets either reference (i) a static basket of Reference Assets that does not undergo any changes while the structured note is outstanding or (ii) a basket of Reference Assets that undergoes changes only pursuant to an index, formula, or algorithm that does not involve the exercise of human discretion and that is disclosed at the inception of the transaction. As a result, such structured notes generally should not subject be to the Basket Contract Regulations.

However, certain indices do involve the exercise of human discretion by the index committee or other governing body—for example, many indices permit the index committee to make discretionary changes to the index methodology[420] and some indices arguably involve human discretion (*e.g.*, environmental, social, and governance ("ESG") oriented indices that determine composition based on a potential index component's ESG score). Such indices can present difficult interpretive issues under the Basket Contract regulations.[421]

iii. Exception for Debt

The Basket Contract Regulations do not apply to a contract that is treated as a CPDI or VRDI.[422] Accordingly, the Basket Contract Regulations are not relevant to Debt Notes. Thus, only

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[419] *See* Treas. Reg. § 1.6011-16(b)(4)(ii).

[420] For example, the index committee for the Dow Jones Industrial Average index (the "DJIA") determines the composition of the index based on general guidelines, not objective rules. *See* Down Jones Averages Methodology, https://www.spglobal.com/spdji/en/documents/methodologies/methodology-dj-averages.pdf (last visited Dec. 27, 2025). The Basket Contract Regulations generally do not apply to indices that "track[] a broad market or market segment," so most structured note tax practitioners do not believe that a Prepaid Derivative Note linked to the DJIA should be treated as a reportable transaction under the Basket Contract Regulations. In the case of certain other indices, however, it may be more difficult to conclude that the index is not discretionary or and is treated as a reportable transaction.

[421] *See* Young, *supra* note 417, at 47 ("The 'objective financial information' standard in the designee exception, and the exception for rules-based amendments in the discretion exception, do not address all modern index methodologies (*e.g.*, environmental, social, and governance (ESG) index methodology may look to non-financial that is nonetheless objective).").

[422] *See* Treas. Reg. § 1.6011-16(d)(2).

a Prepaid Derivative Note can be a potential listed transaction under the Basket Contract Regulations.

iv. Exception for Certain Indices

The Basket Contract Regulations provide, for purposes of determining whether a person is the taxpayer's "designee," that a person will not be treated as compensated by the taxpayer as a result of "[t]he person's use of, the person's payment of a licensing fee for the right to use, or the person's authority to suggest, request, or determine changes in the assets included in a widely used and publicly quoted index that is based on objective financial information or an index that tracks a broad market or a market segment."[423] Based on this exception, many structured note tax practitioners take the position that a Prepaid Derivative Note generally should not be subject to the Basket Contract Regulations if it is linked to (i) a widely used and publicly quoted index that is based on objective financial information or (ii) an index that tracks a broad market or a market segment. There is no guidance on what it means for an index to be "widely used," "publicly quoted," or "based on objective financial information"; similarly, there is no guidance on the definition of "broad market" or "market segment." Accordingly, outside of obvious cases, such as Prepaid Derivative Notes linked to very widely-used indices, such as a the S&P 500, it may be difficult to determine whether an index qualifies for either of these exceptions.

v. Exception for Changes to Account for Market Events

The changes discussed *supra* in Part III.h generally involve a change to the Reference Assets to respond to unanticipated market events. The Basket Contract Regulations provide that the taxpayer (or its "designee") will not be treated as having the right to alter or amend the Contract Rules solely because such person has the authority "to respond to an unanticipated event outside of [the holder's] control, such as a stock split, merger, listing or delisting, nationalization, or insolvency of a component of a basket, a disruption in the financial markets for specific assets or in a particular jurisdiction, a regulatory compliance requirement, force majeure, or any other unanticipated event of similar magnitude and significance."[424] Note that this exception merely provides that *a right* to change the Contract Rules will be disregarded. Nevertheless, the better reading of the Basket Contract Regulations is that *actual changes* to the reference basket to account for such events should not cause a structured note to be treated as a listed transaction.

vi. Conclusion

The IRS's decision to designate basket contracts as reportable transactions under a broad set of ambiguous rules, originally enshrined in the notices cited in footnote 409 and now contained in the Basket Contract Regulations, has haunted the financial products landscape for over a decade, and has presented significant interpretive difficulties for structured notes tax practitioners. One can

[423] Treas. Reg. § 1.6011-16(b)(3)(ii)(B).

[424] Treas. Reg. § 1.6011-16(b)(4)(iii)(C).

only hope that the IRS and Treasury take into account comments from taxpayers and practitioners to clarify the rules and limit their scope to abusive and tax-motivated transactions.[425]

j. Physical Settlement

Certain structured notes (generally, Prepaid Derivative Notes) provide for physical settlement upon maturity. Generally, as a result of how most notes are designed, this will occur only in the event an investor experiences a loss with respect to its structured note.

Although the matter is not free from doubt, most structured note tax practitioners take the position that physical settlement of a structured note is not a taxable event. Rather, physical settlement should be treated as an acquisition by the holder of the Reference Asset in exchange for the holder's payment of the issue price. This theory is based on the general treatment of physical settlements of forward contracts and options.[426] When an option is settled by delivery of the underlying property, the acquiror of the property (*i.e.*, the purchaser of a call option or the writer of a put option) generally does not recognize gain or loss.[427] The same is true with respect to the physical settlement of (non-prepaid) forward contracts.[428] Finally, although there is no direct authority on the subject, the same should be true with respect to prepaid forward contracts.[429] There are several statutory exceptions to the general rule that that the physical settlement of a derivative is not a taxable event—*e.g.*, taking delivery with respect to a Section 1256 contract causes the contract to be marked to market[430]—but these exceptions only prove the general rule.

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[425] *See supra* note 413.

[426] *See* Peaslee, *supra* note 284, at n.96 and accompanying text ("[W]here the derivative is converted into property, the conversion may take place according to the terms of the contract. The two most obvious examples are options or forward contracts to buy property. The purchase of property according to such a contract is not a taxable event (subject to some statutory exceptions).").

[427] *See Helvering v. San Joaquin Fruit & Inv. Co.*, 297 U.S. 496 (1936); Rev. Rul. 78-182, 1978-1 C.B. 265.

[428] *See* Matthew A. Stevens, *Taxation of Non-Equity Derivatives*, 187-1st TAX MGMT. PORT. (BNA), at IV.B.1.a (2024). ("The buyer taking delivery of the property is similarly treated as simply purchasing the property for the contract price."); Sam Chen & Paul J. Kunkel, *Taxation of Equity Derivatives*, 188-nd TAX MGMT. PORT. (BNA), at IV.B.1.a (2024), at I.B.2.a ("[T]he buyer takes a basis in the stock and realizes gain or loss upon its ultimate disposition of the shares. The buyer's holding period in the underlying property starts the day after the sale occurs and does not include the period the buyer held the contract.").

[429] *See* N.Y. State Bar Ass'n, *Timing And Character Rules For Prepaid Forwards And Options* (Mar. 26, 2001), at 4 n.3 ("Although there is no clear authority for the treatment of prepaid forwards under current law, it generally is believed that sellers who receive a prepayment on a prepaid forward do not have income as long as the prepaid forward is not viewed as a sale or a constructive sale. . . . Physical settlement is a realization event for the seller, but not for the buyer, who is treated as purchasing property.").

[430] *See* Section 1256(c)(1). *See also* Section 988(c)(5) (addressing physical settlement of a forward contract, futures contract, option, or similar instrument that is a section 988 transaction); Section 1260(f) (addressing physical settlement of a constructive ownership transaction).

Accordingly, even though it is not entirely clear whether any given structured note is technically a forward contract or option for U.S. federal income tax purposes,[431] practitioners generally extend these principles to structured notes, concluding that the physical settlement of the note should not be taxable event for the holder. If the physical settlement of a structured note is not a taxable event, the noteholder's holding period in the Reference Asset will begin on the day after the day of acquisition—*i.e.*, there is no "tacking" of the holding period, since this is an acquisition of property for cash, albeit with deferred delivery.[432] The holder's tax basis in the Reference Asset should be the holder's tax basis in the structured note.[433]

If the holder receives cash in lieu of physical shares, then the holder will need to allocate its tax basis in the structured note between whole shares and the cash in lieu of fractional shares. Although it is not entirely clear, the better answer is that the holder should recognize capital gain or loss equal to the difference between the cash received and the tax basis in its structured note allocated to such cash. Moreover, although this is also not clear, the better view is that such gain or loss attributable to cash in lieu of fractional shares is *short-term* capital gain or loss.[434] This is premised on the theory that the holder is deemed to have received hypothetical fractional shares and then immediately exchanged them for cash. Several revenue rulings reach this conclusion in the case of cash paid in lieu of fractional shares in corporate reorganizations, when the cash represents merely a mechanical rounding exercise and is not a separately bargained-for consideration.[435] Cash paid in lieu of the delivery of fractional shares upon the physical settlement of a structured note is not separately bargained-for consideration, and thus the hypothetical construct of these rulings should apply.

Nonetheless, because this conclusion is not free from doubt, some issuers and structured note tax practitioners include tax disclosure for physically settled notes that reads something like the following:

> It is possible that physical settlement of the structured note could be treated for U.S. federal income tax purposes as a taxable settlement of the notes followed by a purchase of the Reference Asset. If the transaction is so treated, (i) holders should recognize capital gain or loss equal to the difference between the FMV of the Reference Asset received and the holder's tax basis in the structured note, (ii) holders should take a tax basis in the Reference

[431] In the case of most RevCons (and certain CLNs), the issuer and holder affirmatively treat the structured note as consisting in part of a put option, so the authorities cited in note 427 *supra* are directly on point.

[432] *See* Rev. Rul. 70-598, 1970-2 C.B. 168; *Sheets v. Selden's Lessee*, 69 U.S. (2 Wall.) 177 (1864).

[433] *See supra* note 428.

[434] *See* Kunkel, *supra* note 6, at 17 ("If the holder [of a reverse convertible that is physically settled] receives cash in lieu of fractional shares, the holder will realize short-term capital gain or loss equal to the difference between the amount of cash received and the basis in the fractional shares.").

[435] *See* Rev. Rul. 69-34, 1969-1 C.B. 10; Rev. Rul. 66-365, 1966-2 C.B. 116; Rev. Rul. 72-57, 1972-1 C.B. 103; Rev. Rul. 81-81, 1981-1 C.B. 122. *See also* PLR 201542004 ("The receipt of cash by a Controlled shareholder in lieu of a fractional share of Combination Partner stock . . . will be treated for federal income tax purposes as if the fractional share had been distributed to the Controlled shareholder . . . and then had been disposed of by the Controlled shareholder for the amount of cash in a section 1001(a) sale or exchange.")

Asset equal to its FMV at the time of delivery, and (iii) holders' holding period in the Reference Asset would begin on the day after holders receive the Reference Asset.

Moreover, many issuers and their advisors include disclosure providing that ownership of the Reference Asset could give rise to adverse U.S. tax consequences for holders (*e.g.*, if the Reference Asset consists of shares of a domestic corporation, U.S. withholding taxes generally would be imposed on dividends paid by the domestic corporation to Non-U.S. Holders).

k. Foreign Asset Reporting

i. Overview

Under Code Sec. 6038D, any individual who holds any interest in a "specified foreign financial asset" (an "SSFA") during the taxable year is required to attach an information statement to their U.S. federal income tax return if the aggregate value of the SSFAs in which the individual holds an interest exceeds $50,000 for the taxable year "(or such higher dollar amount as the Secretary may prescribe)."[436]

Treasury regulations provide that this requirement applies to "specified persons," which are as follows: (i) "specified domestic entities,"[437] (ii) U.S. citizens, (iii) resident aliens, (iv) nonresident aliens for whom an election under Code Sec. 6013(g) or (h) is in effect, and (v) nonresident aliens who are bona fide residents of Puerto Rico.[438] The Treasury regulations set forth a general rule that a specified person must file Form 8938 if the person has an interest in one or more SSFAs and those assets have an aggregate fair market value exceeding either $50,000 on the last day of the taxable year or $75,000 at any time during the taxable year.[439] Married specified individuals filing jointly are required to file Form 8938 only if the aggregate value of all of the SSFAs in which either spouse has an interest exceeds $100,000 on the last day of the taxable year or $150,000 at any time during the taxable year.[440] Higher thresholds apply to qualified individuals under Code Sec. 911(d)(1) and their spouses that file jointly.[441]

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[436] The aggregate value of any SFFAs in which an individual has an interest is presumed to exceed the reporting thresholds if the Secretary determines that the individual has an interest in one or more SSFAs and has not provided sufficient information to demonstrate the aggregate value of the assets. This determination applies for purposes of assessing penalties. *See* Code Sec. 6038D(e). The penalties for noncompliance are severe, but penalties will not apply for any failure to report that is shown to be due to reasonable cause and not due to willful neglect. *See* Code Sec. 6038D(d) & (g).

[437] A specified domestic entity is a domestic corporation, a domestic partnership, or a trust described in Code Sec. 7701(a)(30)(E), if such entity is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets. *See* Treas. Reg. § 1.6038D-6(a).

[438] *See* Treas. Reg. § 1.6038D-1(a)(1)–(2).

[439] *See* Treas. Reg. § 1.6038D-2(a)(1).

[440] *See* Treas. Reg. § 1.6038D-2(a)(2).

[441] *See* Treas. Reg. § 1.6038D-2(a)(3)–(4).

Under Code Sec. 6038D(b), an SSFA is defined as any financial account maintained by a foreign financial institution,[442] and, to the extent not held in an account at a financial institution, (i) any stock or security issued by any person other than a "United States person" (as defined for U.S. federal income tax purposes), (ii) any financial instrument or contract held for investment that has an issuer or counterparty that is not a "United States person" (as defined for U.S. federal income tax purposes), and (iii) any interest in a foreign entity. The regulations provide the following examples of SSFAs that are not financial accounts: (i) stock issued by a foreign corporation; (ii) a capital or profits interest in a foreign partnership; (iii) a note, bond, debenture, or other form of indebtedness issued by a foreign person; (iv) an interest in a foreign trust; (v) an interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement with a foreign counterparty; and (vi) any option or other derivative instrument with respect to any of the foregoing or with respect to any currency or commodity that is entered into with a foreign counterparty or issuer.[443] A specified person has an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the SSFA are or would be required to be reported, included, or otherwise reflected by the specified person on an annual return, even if no such items arise during any given taxable year.[444]

ii. Application to Structured Notes

Because SSFAs are broadly defined to include a "derivative financial instrument" that is entered into with a foreign counterparty or issuer, structured notes issued by an issuer that is a foreign corporation should generally constitute SSFAs, to the extent not held in an account at a financial institution.[445] Accordingly, such issuers and their advisors generally disclose that Code Sec. 6038D reporting requirements could apply to such structured notes.

l. Estate Taxes

i. Overview

In general, U.S. citizens are subject to the estate tax on their worldwide estates, even if they reside abroad.[446] Non-citizen non-residents, however, are subject to estate tax only on their "U.S.

[442] An asset held in a financial account maintained by a foreign financial institution is not required to be separately reported on Form 8938. *See* Treas. Reg. § 1.6038D-3(a)(1).

[443] *See* Treas. Reg. § 1.6038D-3(d).

[444] *See* Treas. Reg. § 1.6038D-2(b)(1).

[445] *See* Code Sec. 6038D(b).

[446] *See Cook v. Tait*, 265 U.S. 47 (1924) ("[T]he native citizen who is taxed may have domicile, and the property from which his income is derived may have situs, in a foreign country and the tax be legal — the government having power to impose the tax").

situs" property.[447] Accordingly, it is important to determine whether a structured note held by a Non-U.S. Holder is U.S. situs property.

ii. Debt Notes

The application of the situs rules to Debt Notes is reasonably straightforward.

Debt obligations of a "United States person" (as defined for U.S. federal income tax purposes) are U.S. situs property, subject to the exception in Code Sec. 2105(b)(3), discussed below.[448] Accordingly, if the issuer of the structured note is not a "United States person," it appears unlikely that Debt Notes issued by such an issuer would be U.S. situs property. However, "deposits" with a domestic branch of a foreign corporation (if such a branch is engaged in the commercial banking business) are treated as U.S. situs property.[449] Some non-U.S. issuers issue Debt Notes from their U.S. branches—could these be U.S. situs property?[450] Although the definition of "deposit" for estate tax purposes is not entirely clear, the authorities seem to define the term "deposit" in its conventional sense,[451] and loans generally are not "deposits" for this purpose.[452] Accordingly, it does not appear likely that Debt Notes should be treated as "deposits" for this purpose. Even if a structured note is treated as a deposit made to a U.S. branch of a non-U.S. issuer,[453] it may be eligible for the Code Sec. 2105(b)(3) exception, as discussed below.

What about notes issued by issuers that *are* "United States persons"? Under Code Sec. 2105(b)(3), a debt instrument is not treated as U.S. situs property if payments on the note, if received by the decedent at the time of death, would have qualified for the portfolio interest exemption (without regard to whether the requirement to provide a Form W-8 is satisfied). Since

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[447] See Code Sec. 2103 ("For the purpose of the tax imposed by section 2101, the value of the gross estate of every decedent nonresident not a citizen of the United States shall be that part of his gross estate . . . which at the time of his death is situated in the United States.") Treas. Reg. § 20.2103-1 ("[I]n the case of a nonresident not a citizen, only that part of the entire gross estate which on the date of the decedent's death is situated in the United States is included in his taxable estate.")

[448] *See* Code Sec. 2104(c)(1)

[449] *See* Code Sec. 2104(c).

[450] This discussion assumes that the Debt Note is not a certificate of deposit (a "CD") or otherwise designated as a deposit for non-tax purposes.

[451] Generally, money in checking, savings and unrestricted agency accounts, and CDs are deposits. *See* Michael A. Heimos, *Non-Citizens — Estate, Gift, and Generation-Skipping Transfer Taxation*, 837-4th TAX MGMT. PORT. (BNA), at IV.C.5 (2024). *See also Estate of Gade*, 10 T.C. 585 (1948); *Estate of Forni*, 47 B.T.A. 76 (1942); Rev. Rul. 82-193, 1982-2 C.B. 219.

[452] *See Todd v. United States*, 46 F.2d 589 (Ct. Cl. 1931) ("But we do not think the money was deposited in the sense that the word 'deposit' is used in the statute. It was clearly the intent of Congress to require the deposit to be made in the same manner that it would have been in an ordinary bank. The receipt and the accompanying circumstances show that the transfer of the check constituted a loan rather than a deposit, and we have so found.").

[453] GCM 38916 (Sept. 30, 1981) ("We believe that the determination of whether deposits are considered within or without the United States for estate tax purposes depends on whether the deposits are characterized by a 'debtor-creditor' relationship.").

interest and OID with respect to most Debt Notes should qualify for the portfolio interest exemption, such notes should not be treated as U.S. situs property even if issued by an issuer that is a "United States person" (as defined for U.S. federal income tax purposes).

iii. Prepaid Derivative Notes

The application of the situs rules to Prepaid Derivative Notes is significantly more challenging. There is very limited guidance on when a derivative, like a Prepaid Derivative Note, would be treated as U.S. situs property. Generally, intangible property owned by a non-citizen non-resident is deemed to be a U.S.-situs property if (i) the written evidence of the property is not treated "as being the property itself" and (ii) the intangible is "issued by or enforceable against" a domestic corporation.[454] One treatise states: "If the property is a stock option, the result would ostensibly be solved by the application of the rules concerning general intangibles. Thus, where the issuer of the option is a domestic corporation, the option would have situs in the United States."[455]

Generally, in the modern financial landscape, the "written evidence" of a Prepaid Derivative Note is not treated "as being the property itself." Accordingly, the analysis should generally turn on whether the Prepaid Derivative Note is "issued by or enforceable against" a domestic corporation. Thus, although the matter is not free from doubt, it would appear that Prepaid Derivative Notes issued by domestic corporations are likely to be U.S. situs property, and Prepaid Derivative Notes issued by foreign corporations are unlikely to be U.S. situs property. Nonetheless, even non-U.S. issuers of Prepaid Derivative Notes generally include in their offering materials tax disclosure along the following lines:

> While the matter is not entirely clear, Non-U.S. Holders should note that, absent an applicable treaty benefit, the Prepaid Derivative Notes are may be treated as U.S. situs property, subject to U.S. federal estate tax. Such Non-U.S. Holders should consult their own tax advisors regarding the U.S. federal estate tax consequences of investing in a Prepaid Derivative Note.

IV. CONCLUSION

Structured notes are a significant part of the modern financial landscape, and they present a diverse array of endlessly fascinating tax issues. Many of these issues arise from the baseline lack of guidance on the taxation of derivative financial instruments. Although it is possible that future guidance may be forthcoming from Congress or the IRS, history has shown that such efforts tend only to compound the complexity. This paper is a humble attempt to add to the small volume of commentary on these challenging and interesting financial instruments.

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[454] *See* Treas. Reg. § 20.2104-1(a)(4). Such intangibles enforceable against U.S. residents and governmental units are also U.S. situs property. *See id.*

[455] *See* Heimos *supra* note 451, at IV.D.3.