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When hedging constitutes a sale

Two Tax Court decisions show that certain transactions can have costly consequences

By Robert N. Gordon

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In two cases involving the hedging of appreciated stock positions, the U.S. Tax Court recently ruled that the investors who took the cases to court should be taxed as if they had sold their stock at the time that they entered into the hedging transactions.

Although both rulings leave open the possibility that hedging can be accomplished without negative tax consequences, they underscore the importance of thorough planning when considering hedges.

In the first case, an investor named Calloway held about $100,000 worth of IBM shares and borrowed 90% of the value of the shares for a three-year period from Derivium Capital LLC. Derivium's only re-course against Mr. Calloway for both the interest and the principal was the value of the IBM shares.

The borrower would either walk away from the loan at the end of the term or pay off the loan and get back the shares. Mr. Calloway gave Derivium the IBM shares to hold as collateral for the note.

He didn't have the right to get the shares back until the note was paid; the note couldn't be prepaid.

In the Calloway case, several developments took place that didn't favor the investor.

First and foremost, Derivium immediately sold the IBM stock it took in as collateral. As a result, it was left without shares if the borrower wanted to repay his loan and reclaim his shares.

Moreover, Derivium didn't hedge its exposure to Mr. Calloway in any way, and it seems that Derivium followed that practice with all its clients. Eventually, when enough clients attempted to pay off their loans and get their stock back, Derivium went into bankruptcy.

Mr. Calloway also took steps that were ill-advised.

First, he never included in his tax returns any of the IBM dividend income to which he was entitled during the life of the loan. Then, because the value of the IBM shares when the loan's three-year term elapsed was less than the amount that Mr. Calloway owed to Derivium, he defaulted on the loan and forfeited the shares to Derivium.

But he never reported the stock as being sold for tax purposes.

The court found that the actions of both Derivium and Mr. Calloway weren't consistent with the terms of the loan and held that a loan didn't exist. Instead, it found that he had sold the stock.

In the second case, entities related to investor Philip Anschutz held shares in Anadarko Petroleum Corp. and Union Pacific Corp., and entered into a 10-year prepaid forward contract with Donaldson Lufkin & Jenrette Inc., which since has been acquired by Credit Suisse Group Inc.

The investor put his shares up as collateral with respect to the contract, and allowed DLJ to borrow the shares. Mr. Anschutz received 75% of the value of the stock under the prepaid forward contract and 5% of the value of the stock for lending it to DLJ.

Under the forward contract, through the variable number of shares to be delivered at maturity, he didn't bear any risk of loss on changes in the stocks' prices, but retained the first 50% of any price increases.

Disagreeing with the government, the Tax Court found that the prepaid forward contract had enough variability so that it didn't constitute a constructive sale.

However, the court combined the stock loan agreement and the prepaid forward agreement into one agreement for tax purposes and held that Mr. Anschutz had entered into a stock lending agreement that reduced the risk of loss with respect to the lent securities.

As such, it didn't meet the requirements set out in the Internal Revenue Code (Section 1058) for non-recognition treatment for securities loans. Therefore, the court held that the transfer of the securities resulted in a taxable transaction.

The common thread in these two cases is that taxpayers can inadvertently trigger a gain because of technical deficiencies in how their transactions are executed and/or documented. The appeals of these cases could shed additional light on the matter.

It appears from the Tax Court opinions that with planning, similar transactions could be structured so as not to trigger a taxable event.

For example, if the lender in a non-recourse loan doesn't sell the client's stock, a gain probably won't be triggered. Similarly, clients should probably not lend their shares to the counterparty in a prepaid variable forward contract.

Before engaging in any hedging transaction, take time to consider any missteps that could jeopardize the entire exercise.

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