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TITLE: Living and Dying with Derivatives: An Estate Planner's Perspective

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Anne K. **Hilker** and Anthony P. Marshall analyze equity derivatives as tools for risk management and discuss their use in tax and estate planning.

TEXT: Introduction

As wealth in private and public equity increases, so does the estate planner's role in preserving and transmitting this wealth. Derivative financial products manage risks that are common to holding large, undiversified equity positions. The products may be designed to defer taxable gain, or to simply manage market risk during a required holding period. As a result, equity derivatives are key wealth management tools that estate planners must understand and use.

We have prepared a basic primer on equity derivative products, which we have organized by the risk each product manages. We also make some tax and estate planning observations.

Background

In this article, the entrepreneur, *E*, may enter into an equity derivative contract because he believes there is substantial risk that his holding of ABC stock will underperform a variety of market measures. *E* may be worried about price volatility in the stock, in which case he will seek pricing protection. Alternatively, *E* may be worried that his ABC holdings will underperform a diversified portfolio, in which case he can enter into a futures contract position, exchange fund or a pledge and loan. While key features of these products can pose significant securities and commodities law issues, a discussion of these issues is beyond the scope of this article.

What Is a Derivative?

A derivative is a financial product whose value is determined by reference to the value and characteristics of another financial product. With regard to stocks, options and forward contracts are derivatives and represent rights or obligations to buy or sell the underlying stock. The death of a party to a derivative transaction may create an estate asset or liability, depending upon the rights or obligations under the derivative contract.

The examples that follow describe different derivative contracts *E* may enter into with a financial institution, *FI*, to achieve investment goals and minimize risks while recognizing income and estate tax implications, should *E* die while such a contract is open.

Derivatives Glossary

Before looking at the examples, it is helpful to have a few of the key terms in mind. These are as follows:

Long and Short Positions. A "long" position is ownership of the underlying asset. If *E* owns stock of ABC Company, he is long in that stock. A long position can also refer to the holder of an option who has the right to buy or sell the underlying stock. The writer, or seller, of an option, who has the potential liability (*i.e.,* the obligation to buy or sell the underlying stock) holds the short position.

In-the-Money. "In-the-money" means that *E* has a profit built into the transaction as of any given measurement date. For example, if *E* has a call option on stock at a fixed price (the right to buy) and the fixed price is less than the market price, the call option is in-the-money. If *E* has a put option on stock at a fixed price (the right to sell) and the fixed price is greater than the market price, the put option is in-the-money. "Out-of-the-money" is the opposite of in-the-money. "At-the-money" is when the fixed, or strike, price and market price are the same.

Time as Key Factor. Because derivatives are executory contracts, they create rights or obligations that arise in the future. The risk is covered only for the length of the contract.

Nature of the Risk. For the contract period, the risk addressed may vary or may be a combination of several risks. It may fix high or low values on the referenced assets. The contract may give *E* the ability to diversify his investment risk without having to sell his ABC stock and reinvest the proceeds.

European-Style and American-Style Options. A European-style option may be exercised only during a specified period of time just prior to its expiration. An American-style option may be exercised at any time between the date of purchase and the expiration date. Most exchange-traded options are American-style and have fixed terms. Over-the-counter options are often European-style and their terms are negotiable.

Notional Principal Amounts and Contracts. A notional principal amount is any specified amount of money or property which, when subject to a multiplier, measures a party's rights and obligations under a contract but is not borrowed or loaned between the parties as part of the contract. A notional principal contract is defined in the Regulations to the Internal Revenue Code (the "Code") and includes contracts covering such financial arrangements as swaps, caps and floors.

Constructive Sales. Since June 8, 1997, Code Sec. 1259 has limited investors' ability to engage in derivative transactions with respect to appreciated financial positions. If the constructive sale rules apply, the investor will be required to recognize taxable gain upon entering into a constructive sale transaction, even though no taxable sale may have occurred. Accordingly, in considering a risk management strategy with respect to his holdings in ABC stock, *E* (and his advisors) will need to consider transactions outside the scope of the constructive sale rules of Code Sec. 1259 . In this manner, *E* can defer the recognition of gain or loss on his ABC stock until the closing of the contract.

Section 1256 Contracts. A Section 1256 contract includes regulated futures contracts and exchange-traded nonequity options. [2] A typical Section 1256 contract is a futures contract on a broad-based equity index or an exchange-traded option on a futures contract. Section 1256 contracts, by definition, are required to be marked-to-market on the last business day of the tax year, which requires an annual tax accounting of all gains and losses, realized and unrealized. Regardless of the taxpayer's holding period, Section 1256 contract gain or loss is treated as 60-percent long-term and 40-percent short-term.

Pricing Protection

In today's market environment, many entrepreneurs find themselves holding a large concentrated position

of stock with low-cost basis. The stock may have been acquired through an initial public offering or from the sale of a private company to a large, publicly traded corporation in a tax-free exchange, or merely be from a long-standing family or personal investment.

Any concentrated position presents investment risks. For fiduciaries, the first principle of the prudent investor standard is diversification, which should be as equally imperative for the individual entrepreneur.

Diversification through an immediate sale, however, is not always appropriate. Current recognition of capital gains may be detrimental and/or the entrepreneur may want to retain voting rights in the stock for a period of time. The risk that the value of *E*'s stock in ABC will fall can be addressed by two kinds of derivative products that offer pricing protection: cashless collars and prepaid variable forward contracts.

Collars

If *E* wants to protect against a significant decline in a large stock position, he can establish a floor for the stock's value by purchasing a put option. A put is an option that gives the holder the right to sell -- or "put" -- to the writer of the option a specified amount of stock at a specified price within a period of time.[4]

Collar Example. Suppose *E* has 50,000 shares of ABC Corporation, trading at $100 per share. He is optimistic about the stock's long-term prospects but is concerned about recent market turbulence, and doesn't want to see his $5 million position fall below $4 million ($80 per share). If he purchases an American-style put at a strike price of $80 per share for 12 months, he could sell his stock any time during that period for $80 per share or receive in cash the difference between the shares' then market price and the strike price.

Normally, each equity option represents 100 shares of stock, so that the price per contract is 100 times the price of the option. Assuming $4 is the price for the 12-month $80 put, *E* would pay a put option premium of $200,000 ($4 x 100 x 500). *E* could regard this as the cost of insurance that during the option period his stock will never be worth less to him than $4 million. If the stock does not fall below $80 per share before the option expires, *E* would have paid $200,000 for insurance he did not use.

By selling a call option, *E* can offset the cost of the put while retaining its protection if he is willing to give up some of the stock's up-side potential. *E* (as the writer of the call) gives the buyer the right to acquire -- or "call" on *E* to sell -- the stock at a fixed price during the term of the call. Buying a put and selling a call on the same stock position is called establishing a "collar." If the proceeds from selling the call match the cost of buying the put, the collar is called a "costless collar."

Continuing with the above example, assuming *E* could sell for $4 a 12-month call option at a strike price of $130, then the costs of establishing the collar would cancel each other out (ignoring commissions and fees). However, *E* would have given up the potential appreciation over $130 per share, since that is the price at which he has agreed to sell the stock.

Another advantage of the collar is *E*'s ability to borrow up to 90% of the put-protected value of the collared stock.[6] The terms of the loan can be more attractive than those for traditional secured credit and other than the collared shares, there should be no necessity to provide collateral if the price of the stock falls.

Tax Treatment of Collars. Establishing a properly structured equity collar should not be a taxable event. Each option that forms part of the collar is regarded as an open transaction until it lapses, the parties enter into a closing transaction or the option is exercised.[8] However, the purchase of the put option and the sale of the call option create separate straddles with the long stock position.[10] Since the options relate to a single class of equity securities, even if they are exchange-traded they will not be regarded as Section 1256 contracts,[12] which would require them to be marked-to-market at year-end. Entering into a collar also avoids constructive sale treatment under Code Sec. 1259 and the immediate recognition of gain.[14]

The tax consequences of the put position of the collar will depend upon how the put is terminated. If the put lapses (expires without exercise or sale), *E* is treated as if he sold the option, and its cost (premium paid) plus any commissions and fees result in a capital loss.[16] The loss will be long-term or short-term

depending upon how long *E* held the stock before purchasing the put.[18] Under the straddle rules, the loss will be deferred so long as *E* has unrecognized gain in the stock equal to or greater than the loss.[20]

If *E* closes the put transaction by selling the put, he would recognize gain or loss based on the difference between the amount realized on the sale and the premium originally paid to purchase the put (including commissions and fees). Under the straddle rules, any gain will be short-term (regardless of how long the put was held),[22] and the characterization of any loss depends on how long *E* held the stock before purchasing the put.[24] Any loss will be deferred so long as *E* has unrecognized gain in the stock equal to or greater than the loss.[26]

If *E* exercises the put and delivers the appreciated stock, under the straddle rules the gain on the stock will be long-term only if he held the stock for the long-term holding period before he purchased the put.[28] The gain is also subject to the short-sale rules. These rules will convert a long-term gain into a short-term gain if, during a one-year period prior to purchasing the put or at any time the put option was outstanding, *E* purchased the same or substantially identical ABC shares as those subject to the put.[30]

If *E* exercises the put with newly purchased shares, any gain upon delivery will be short-term and any loss will be short-term, unless the shares subject to the put were held for the long-term holding period before the put was purchased. In that case, under the short sale rules, the loss would be long-term.[32]

When *E* disposes of the call option that forms part of the collar, any gain (equal to the premium received less commissions and fees) from a lapse or a closing transaction will be short-term.[34] Any loss from a closing transaction will be short-term or long-term depending upon *E*'s holding period for the ABC stock at the time the call was sold,[36] and will be subject to the loss deferral rules of Code Sec. 1092(a) .

If the call option is exercised by the holder, requiring *E* to sell the appreciated stock, the gain will be short-term or long-term depending upon *E*'s holding period for the stock at the time he sold the call option.[38]

Use in Estate Planning. A collar may be appropriate for an elderly entrepreneur in the following circumstances: *E*, who is concerned about market volatility, holds a large appreciated position in a stock that he wants to retain for his family and a portion of the stock must be sold to raise cash for the payment of estate taxes and administration expenses. If *E* creates a collar, he may be able to protect the stock from a forced sale below the put strike price in the midst of a short-term market decline. A European collar could extend through an anticipated period of the investor's death until the subsequent due date of the federal estate tax payment.

E could also use the collar to raise cash by borrowing against the put-protected shares. With the borrowed cash, he could make pre-death gifts, thereby reducing his taxable estate. A cash gift has the advantage of not passing along an embedded, capital-gains tax liability, as would a gift of appreciated stock. Appreciation in the stock could offset the cost of borrowing.[40]

If *E* dies while his stock is collared, his estate will report the parts of the collar separately. The shares subject to the collar will be reported at their date-of-death value and would receive a step-up in basis. The put and call associated with the collar will be valued at their closing transaction values as of the date of death. The put will be valued at its sales price and the call will be valued at its purchase price.[42] After death, the collar will still exist and the estate will be subject to the straddle rules. However, post-death lapses, closing transactions and exercises of the options will be affected by the imputed, long-term holding period for assets held at death, the step-up in basis of the stock and the new bases for the put and call (their date-of-death values). None of the transactions after death should give rise to income in respect of a decedent (IRD).[44]

Prepaid Variable Delivery Forward

In addition to a collar transaction, the risk that the value of *E*'s stock in ABC will fall can be addressed by a prepaid, variable delivery forward contract (VDF). A VDF is a private contract between an investor and a financial institution, *FI*, whereby the investor agrees to sell a varying number of shares of a particular stock to *FI* at a future date, usually one to five years from the contract date. VDFs have the following

characteristics:

-- The up-front payment on the forward sale is typically between 75 and 85 percent of the current value of the maximum number of shares subject to the contract.

-- Regardless of the price movement of the stock after the sale, no part of the up-front payment ever has to be repaid. This establishes a floor to the investor's exposure to the stock's price fluctuation.

-- VDFs allow the investor to participate fully in any share price increase from the "floor level" (the current price upon which the up-front payment is based) to the "threshold level" (the agreed upon price level at which the investor partially or completely ceases to participate in further appreciation).

-- The amount of shares to be delivered at the closing of the sale is determined by the price of the shares at that time, relative to the floor level and the threshold level.

-- The maximum number of shares to be delivered never exceeds the number of shares upon which the up-front payment was based.

-- To the extent the investor shares in the appreciation of the stock over the floor level, the number of shares required to be delivered at closing will be reduced.

-- Alternatively, the forward sale can be cash-settled by paying cash equal to the value of the shares otherwise to be delivered at settlement.

-- Prior to the maturity of the contract, the investor retains the dividends and voting rights.

-- Generally, the underlying shares are posted as collateral for the contract.

-- Unlike loan proceeds obtained under a secured loan, whereby only 50 percent of the funds can be used to purchase marginable securities, there is no restriction on the use of the up-front payment from a VDF.

VDF Example. The foregoing discussion can be illustrated by the following example: Assume *E* has 50,000 shares of low-basis stock of ABC Company, trading at $130 per share. *E* enters into a three-year participating VDF with *FI* at a notional value of $6,500,000 ($130 x 50,000 shares). The parameters are as shown in the table (numbers are rounded for illustration purposes).

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VDF Example

Duration ....................................................... 3 years

100% Floor Level ............................................... $130.00

120% Threshold Level ........................................... $156.00

Up-Front Payment (% of Floor) .................................. 82.39%

Up-Front Payment ............................................... $5,355,054

Additional Participation ....................................... 16.67%
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Under this structure, *E* will receive the benefit of all the appreciation on the underlying ABC stock from $130 to $156 and 1/6 of any appreciation above $156. This additional percentage participation is an added feature of a participating VDF.[46]

As described above, the number of ABC shares to be delivered by *E* to *FI* upon maturity of the VDF will be determined by ABC's market price at that time, relative to the floor level and the threshold level, as follows:

-- Market price is below floor level. If at maturity the price of the stock is at or below the floor level of $130, *E* keeps all of the up-front payment of $5,355,054 and delivers 50,000 shares to *FI*. At the price of $130, *E* could cash-settle the contract for $6,500,000 (50,000 x $130). If the price of the stock is $104, *E* could cash-settle the contract for $5,200,000 (50,000 x $104).

-- Market price above floor level and less than or equal to threshold level. If at maturity the price of the stock is $156, *E* keeps all the up-front payment of $5,355,054 plus 8,333 shares and delivers 41,667 shares to *FI*. The 8,333 shares retained represent all of the appreciation, from $130 to $156, on 50,000 shares, or $1,300,000 (8,333 x $156). Alternatively, *E* could cash-settle the contract for $6,500,000.

-- Market price above threshold level. If at maturity the price of the stock is above $156, *E* keeps all of the up-front payment of $5,355,054 and the same number of shares, namely 8,333. Alternatively, the cash settlement amount would increase above $6,500,000, being determined by the stock price at maturity and reflecting *E*'s participation in 1/6 of the appreciation above the threshold level of $156.

Tax Treatment of VDFs. Under current law, a correctly structured VDF should postpone recognition of gain on the sale until the maturity of the contract by the delivery of shares or a cash equivalent payment.[48] Because the transaction is treated as the sale of the delivered shares for the up-front amount, gain is measured by the difference between the up-front payment and the basis of the shares delivered.[50] The capital gain recognized upon maturity of the contract by delivery of shares is long-term.[52] If the contract is cash-settled at maturity, gain or loss is measured by the difference between the up-front payment and the cash-settlement amount. Any gain is short-term,[54] and any loss will be long-term or short-term depending upon the holding period of the stock when the contract was entered into.[56] Any loss will be deferred so long as *E* has unrecognized gain in the stock equal to or greater than the loss.[58]

Consequences of Death During Contract Term. Since VDFs are typically transactions that remain open for one to five years, consideration should be given to the consequences of the death of *E* before the contract closes. Generally, the provisions of a VDF permit, at the FI's discretion, early termination of the contract due to *E*'s death. For estate tax purposes, the up-front payment (or assets purchased with the payment and held at death) will be an asset of the estate. The shares subject to the contract are also estate assets and will receive a step-up in basis to the date-of-death or alternate value.[60] Closing the contract at a gain after death does not give rise to IRD.[62]

The obligation under the contract should be regarded as a claim against the estate, and the *FI* can value the claim as if an early termination had occurred on the date of death. The claim itself is not contingent; only the amount is uncertain.[64] When the claim is subsequently settled, either upon early termination or at maturity, more than likely its value will be different from its date-of-death value. Should the difference be taken into account in valuing the claim for estate tax purposes? The answer is uncertain and depends on which line of authority is deemed applicable.[66]

In measuring gain or loss at a later maturity or termination, the amount of the VDF liability used to compute the net estate replaces the up-front VDF payment. Thus, gain or loss upon maturity will be measured by the difference between the date-of-death value of the VDF liability and the date-of-death value of the number of shares delivered. The capital gain or loss would be long-term.[68] If the contract is cash-settled, gain or loss is measured by the difference between the date-of-death value of the VDF liability and the cash payment. Any gain would be short-term, while any loss would be long-term.[70]

Using the previous example, suppose *E* dies during the three-year period before maturity, at a time when the price of the stock is $150 per share. The up-front payment of $5,355,054 would be included in the taxable estate, as would assets acquired with the payment, which would receive a step-up to date-of-death values. Also, the 50,000 shares of ABC Company at $150 per share would be an asset of the estate and receive a step-up in basis.

Under the terms of the contract, *FI* may declare *E*'s death to be a terminating event and give notice of termination to the estate. The termination date cannot be earlier than the date notice is given. In the event of an early termination, the amount required to terminate the contract is determined by *FI*. Using the date-of-death value of $150 per share as the value of the shares for termination purposes, a terminating amount (number of shares to be delivered or cash equivalent) as of the date of death can be determined. Had the VDF terminated at date-of-death, *E*'s estate would have had to pay *FI* $6,500,000 or deliver $6,500,000 worth of ABC stock at $150 per share. Accordingly, $6,500,000 should constitute the estate's obligation under the contract for estate tax purposes, even though it may not be the amount actually delivered upon early termination and probably will not be the amount actually delivered if the contract goes to maturity.

Upon early maturity, if the estate settles by delivering stock, it will incur a long-term gain or loss based on the difference between the proceeds of sale (the $6,500,000 date-of-death valuation of the VDF liability) and the number of shares delivered needed to close the transaction times $150 (the stepped-up basis of the shares). If the VDF is settled in cash, gain/loss would be measured by the $6,500,000 valuation of the VDF liability and the cash used to discharge that liability. Once again, any gain would be short-term and any loss would be a long-term capital loss, deferred under the straddle rules.

Diversification Protection

Exchange Funds

An entrepreneur with a large concentrated stock position can achieve a tax-free diversification through the use of an exchange fund managed by a financial institution. A typical exchange fund might have the following characteristics:

-- The fund will be organized as a partnership or a limited liability company, taxed as a partnership.

-- The fund will exist for at least seven years, and possibly 10 or 12, from the closing of all the contributed shares until its termination.

-- To be eligible to participate in the fund, *E* must be an "accredited investor" as defined in Regulation D under The Securities Act of 1933,[72] and a "qualified purchaser" under The Investment Act of 1940.[74]

-- Investors exchange stock (acceptable to *FI* as manager of the fund) for "interests" in the fund. After the exchange, the investors no longer own the contributed stock.

-- Prior to the closing, the fund will borrow against the contributed securities to purchase sufficient assets, which are not "stock and securities" as defined in Code Sec. 351(e)(1)(B) .[76]

-- For each investor, *FI* will maintain capital accounts consisting of each investor's full and fractional interests (rounded to the nearest 1/10,000 of an interest) in the underlying assets and liabilities of the fund.

-- Interests are transferable only with the prior consent of *FI*. Generally, transfers will be permitted to close family members (spouse, children, grandchildren, parents and siblings), outright or in trust.

-- The net asset value of the fund will be determined on the last business day of each month.

-- Investors will receive unaudited quarterly and audited annual financial statements.

-- Redemptions will be based on the fund's net asset value and will be restricted during the first seven years of the fund.

-- After seven years, redemptions are permitted and are intended to be in the form of a *pro rata* cross-section of all securities in the fund.

Tax Treatment of Exchange Funds. An investor in the fund is treated as a partner for federal income tax purposes and is required to report his allocable share of the fund's income, losses and deductions on his personal income tax return. Therefore, *E*'s initial tax basis in his interests will be his adjusted basis in the securities contributed, plus any cash contributed, and his share, if any, of the fund's nonrecourse liabilities. Upon redemption of all of his interests, *E*'s adjusted tax basis in his interests will become his tax basis in the securities distributed, allocated among them *pro rata* in accordance with the fund's relative tax basis in the securities before the distribution.[78]

Since during the first seven years of the fund *E* may not be able to redeem his entire interest, gifts of interests to family members should be discountable for lack of marketability. The amount of the discount will vary depending upon how close to the end of the seven-year period the gifts are made.

Tax Consequences of Death During Fund Participation. If *E* dies while participating in the fund, his interests are assets of his estate and will receive a step-up basis to their value as reported on the federal estate tax return.[80] However, since the fund will not make an election under Code Sec. 754 , the estate or heirs will be allocated gains, losses and similar items based on the fund's actual basis in its asset, unaffected by *E*'s death.

The estate or heirs may redeem all or part of *E*'s interests at any time. Securities distributed in a complete redemption, or in a partial redemption within two years after death, will receive a step-up in basis equal to the stepped-up basis of *E*'s interests.[82]

Futures Contracts

The risk of holding a single issue can be addressed by contracts that produce the investment return of a basket of stocks. E can use futures contracts to hedge against the possibility that his ABC stock will not perform as well as an equity index. Futures contracts on equity indices are most commonly based on a broad-based stock index, such as the S&P 500 or other broad-based equities index. They typically have the following characteristics:

-- *E* continues to hold his undiversified position in ABC stock. *E* buys the S&P 500 index at its current price, betting that by a specified future date it will have appreciated.

-- *E*'s shares of ABC stock and his long position in the S&P 500 futures contract are two separate transactions.

-- *E* enters into a long futures position in the S&P in the hope that the S&P value will outperform his ABC shares. Any margin requirements *E* has to take on in order to maintain his long position are typically covered with cash or by posting U.S. Treasury Securities. His futures broker will not typically allow him to post his ABC shares.

-- Such contracts do not operate to defer gain, however, since they fall within the definition of a Section 1256 contract.[84] They are therefore marked-to-market at the end of the calendar year, triggering gain or loss at that time.[86]

-- The ABC shares held by *E* are independent of his long position. Because the futures contract position is exchange-traded, entering into an offsetting short futures contract (referred to as a "closing transaction" can readily close out the futures contract.

-- The futures broker typically has the right under the contract with *E* to close out any open positions on *E*'s death.

Equity index futures contracts are an enticing way to hedge against market risk because they are an inexpensive form of hedging compared with options on specific securities. Typically, for an S&P 500 futures contract, *E* would have to deposit only about 6.5 percent of the contract value to a margin account as collateral for the transaction. However, the risks in using index futures for hedging purposes are much greater than with "true" hedges -- *i.e.,* options on specific securities. Factors affecting the stock market as

a whole (market risk) may not have a similar affect on the price of a particular stock. Also, using index futures to hedge against market risk does not protect against company risk -- the risk that factors affecting a particular company, such as industry competition, management strength and product quality, may cause the company's stock to perform differently than the market as a whole.

E's shares in ABC are valued at their market price at *E*'s death and obtain a basis step-up or step-down. *E*'s obligation to make a payment on the futures contract is a liability, and any payment due him is an asset in his estate. Since futures contracts are marked-to-market constantly, a date-of-death value is easily obtainable. For income tax purposes, a payment received in the future by *E*'s estate is not IRD because the contract remains open and subject to decisions by both *E*'s executor and the futures broker.[88]

Unlocking Cash to Diversify: The Pledge and Loan

E may also look to a standard loan where he uses his ABC shares as collateral for the loan. A loan typically has these features:

-- *E* pledges his stock in return for a loan. Typically the loan is capped at 80% of the value of the collateral.

-- *E* remains personally liable for any additional calls for other collateral if the market price of the ABC stock drops. *E* will typically have the right to provide other assets or substitute collateral.

-- *E* typically pays points for the loan and a market interest rate.

-- The loan is not transferable by *E*. The collateral cannot be split from the loan, although different collateral can be negotiated.

At *E*'s death, the loan ends, and *E*'s estate must repay the outstanding loan unless it negotiates a further loan term or renegotiates the terms of the contract. *E*'s stock in ABC has a basis step-up at *E*'s death. The loan is a liability on *E*'s balance sheet and is a deductible debt at *E*'s death.

A loan is an easy-to-understand method of getting cash for nonleveraged gifts, for example, for multiple annual exclusion gifts, direct skips and other tax-favored forms of giving.

FOOTNOTES: n1 Section 1256 contracts are defined in Code Sec. 1256(g) .

n2 The holder of the option is said to be in the long position and the writer of the option in the short position.

n3 If any of the borrowed funds are to be used for the purchase of marginable securities, the investor is limited to borrowing only 50 percent of the stock (Federal Reserve Board, Regulation U).

n4 Code Sec. 1234 . A closing transaction occurs when the investor closes his long position by selling the option and closes his short position by buying the option.

n5 Code Sec. 1092(c) and (d)(3) S1092(d)(3) .

n6 Code Sec. 1256(b) , (g)(3) S1256(g)(3) and (6) S1256(g)(6) . Single stock options, as well as options on narrow-based stock indices, are considered "equity options" and by definition are not considered Section 1256 contracts. Exchange-traded nonequity options, which include options on broad-based stock indices, would be treated as Section 1256 contracts.

n7 Code Sec. 1259(c) . To the extent prescribed in future regulations, a collar may be considered a constructive sale. The mandated regulations due out in this area are to be prospective only, except with respect to "abusive transactions." An abusive transaction would be a collar with such a narrow collar band that the holder retains only minimal potential for gain or loss. Although nothing is certain here, the consensus is that it is extremely unlikely that a *costless* collar would be viewed as abusive.

n8 Code Sec. 1234(a) .

n9 Temporary Reg. § 1.1092(b)-2T(b) .

n10 Code Sec. 1092(a) ; Temporary Reg. § 1.1092(b)-1T(a)(2) . It is unclear whether gains and losses from straddle positions can be netted before applying the loss deferral rule. For example, can a collar holder net the loss from the lapsed put against the gain from the lapsed call or must the entire loss be deferred because of the unrecognized gain in the stock? Code Sec. 1092(a) uses the term "loss", not "net loss" or "gross loss."

n11 Temporary Reg. § 1.1092(b)-2T(a) .

n12 Temporary Reg. § 1.1092(b)-2T(b) .

n13 Code Sec. 1092(a) ; Temporary Reg. § 1.1092(b)-1T(a)(2) .

n14 Temporary Reg. § 1.1092(b)-2T(a)(2) .

n15 Buying a put with respect to a long position in stock is characterized as entering into a short sale, which will close upon the disposition of the put. Code Sec. 1233(b) .

n16 Code Sec. 1233(d) .

n17 Code Sec. 1234(b) .

n18 Temporary Reg. § 1.1092(b)-2T(b) .

n19 Temporary Reg. § 1.1092(b)-2T(a) . The gain will be determined by the difference between the proceeds of sale plus the option premium received (less any commissions and fees) and the investor's basis in the stock.

n20 Because the collared stock would be part of a straddle, interest on the loan would have to be capitalized and added to the basis of the stock. Code Sec. 263(g) .

n21 European collars established with financial institutions generally contain provisions permitting the bank to declare an early termination as a result of death of the investor. Closing transactions values should always be available. TAM 8204017 (Oct. 2, 1981) determined that no deduction is allowable on the estate tax return for the cost of executing closing transactions to eliminate uncertain, contingent obligations of the estate represented by the decedent's written puts and calls. There is a question as to whether this TAM represents good law in today's era of monetization or whether a financial institution's right to declare an early termination would affect the contingency aspect of the obligations. Clearly, the IRS would require the put element of the collar to be included as an asset. It does not seem logical that the call element should be ignored.

n22 Neither the put nor the call represents transactions sufficiently completed by the decedent before death to give rise to IRD. *See* Rev. Rul. 73-524 , 1973-2 CB 307 (proceeds received on sale of securities pledged in pre-death short sale are not IRD and the securities receive a step-up in basis on death). *To the same effect*, LTR 9319005 (Feb. 4, 1993) and LTR 9436017 (June 7, 1994). *See also* Rev. Rul. 71-256 , 1971-1 CB 223 (granting an option to purchase real estate after writer's death is not a pre-death sale and the real estate included in the decedent's estate receives a step-up in basis) and LTR 9325029 (Mar. 25, 1993) (dealing with the exercise after death of an option to purchase real estate granted before death).

n23 In a nonparticipating VDF, *E* would only share in any appreciation up to the threshold level, with all additional appreciation being for the benefit of *FI* .

n24 The constructive sale provisions embodied in Code Sec. 1259 were added to the Code via the

Taxpayer Relief Act of 1997 (P.L. 105-34). These rules were added to combat "short against the box" and other similar transactions, whereby taxpayers effectively disposed of all potential for future gain or loss on some underlying appreciated financial position, while postponing the income tax on a disposition (potentially forever). Although Code Sec. 1259 treats a forward contract as a constructive sale, the VDF is nevertheless an exception to the constructive sale rules. This is because, for purposes of Code Sec. 1259 , a forward contract must provide for the delivery of a substantially fixed amount of some asset, whereas with a VDF the amount of shares to be delivered depends on the share price at maturity.

n25 Although VDFs should be treated as forwards, the IRS has not addressed the tax treatment of these contracts and could take a different view. For instance, the IRS might attempt to treat a VDF, in part, as a so-called "contingent payment debt instrument" for which interest must be accrued on a constant yield basis. *See* Reg. § 1.1275-4 .

n26 The availability of long-term capital gain treatment is premised on the investor having held the shares for more than one year prior to entering into the VDF. Entering into the VDF likely will create a straddle under Code Sec. 1092 because the VDF and the underlying shares should be treated as "offsetting positions" under Code Sec. 1092(c)(2) , since the risk of loss on the shares is substantially diminished by holding the VDF. One consequence of the straddle rules is that the investor cannot obtain long-term capital gain on a sale of the VDF itself because the straddle rules toll the holding period on the contract. Temporary Reg. § 1.1092(b)-2T(a)(1) . However, the straddle rules provide for a long-term gain on long-term positions held before the straddle was created. Temporary Reg. § 1.1092(b)-2T(a)(2) .

n27 Since the VDF that forms part of a straddle with the shares is terminated by cash settlement, rather than by delivery of the shares, Temporary Reg. § 1.1092(b)-2T(a)(1) applies, and any gain will be short-term.

n28 Temporary Reg. § 1.1092(b)-2T(b) .

n29 Code Sec. 1092(a) ; Temporary Reg. § 1.1092(b)-1T(a)(2) .

n30 Code Sec. 1014(a) .

n31 *Supra* note 22.

n32 While the distinction between a non-contingent claim for an uncertain amount and a contingent claim is a delicate one, the difference is quite important. For the noncontingent claim, the problem of valuing the VDF liability is conceptually no different from the problem that normally arises with hard-to-value estate assets. Indeed, the *FI*'s option to terminate the VDF at death should serve to put a value on the VDF at that date. On the other hand, where the very existence of a net liability is at stake (as might occur with an interest rate swap held at death), it's unclear if the liability is even included in the estate. *See* Reg. § 20.2053-1(b)(3) , and TAM 8204017 (Oct. 2, 1981) (written puts and calls not included as claims against estate under Code Sec. 2053 because they are regarded as contingent at death since, depending on future price movements, they might never have to be paid). *Cf., supra* note 21.

n33 Justification for using the value of a settlement subsequent to the date of death can be supported by Reg. § 20.2053-1(b)(3) (estimated amounts) and by those cases and rulings holding that post-death events should be considered in determining the amount deductible under Code Sec. 2053(a)(3) , *viz., C.P. Cafaro Est.*, 57 TCM 1002, Dec. 45,846(M) , TC Memo. 1989-348; Rev. Rul. 80-260 , 1980-2 CB 277; and AOD 2000-004. The contrary view can be supported by *Smith Est.*, CA-5, 2000-1 USTC P 60,366 2000-1 USTC P 60,366 , 198 F3d 515, *rev'g* 108 TC 412, Dec. 52,069 (1997), *Propstra*, CA-9, 82-2 USTC P 13,475 , 680 F2d 1248, *Van Horne Est,* CA-9, 83-2 USTC P 13,548 , 720 F2d 1114, *aff'g* 78 TC 728, Dec. 38,964 (1982), *Cert. denied*, 466 US 980 (1984) and *Ithaca Trust* , SCt, 1 USTC P 386 , 279 US 151.

n34 Code Sec. 1223(11) ; Temporary Reg. § 1.1092(b)-2T(a)(2) , (b) S1.1092(B)-2T(b) .

n35 Temporary Reg. § 1.1092(b)-2T(a)(1) , (b) S1.1092(B)-2T(b) .

n36 An "accredited investor" is an individual who has individually, or jointly with a spouse, a net worth in excess of $1 million or, within the last two years, individual income in excess of $200,000, or joint income with a spouse in excess of $300,000 and the expectation of reaching that same income level in the current year.

n37 A "qualified purchaser" is an individual who owns not less than $5 million in investments. Section 2 (a)(51)(A)(i).

n38 This is necessary for the fund to avoid being characterized as an investment company for the purpose of Code Sec. 721(b) , which would otherwise require *E* to recognize gain on the securities contributed.

n39 Code Sec. 732(b) .

n40 Since the net asset value of the fund is determined on the last business day of each month, the date-of-death value of *E*'s Interests can be determined by pro rating the net asset values before and after death by the number of days between the date-of-death and the valuation dates. *See* Rev. Proc. 84-17 , 1984-1 CB 432 (dealing with the valuation of common trust funds for estate tax purposes).

n41 Code Sec. 732(b) and (d) S732(d) .

n42 Code Sec. 1256(b)(1) .

n43 Code Sec. 1256(a)(1) .

n44 *Supra* note 21.

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