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Money Now, Taxes Later With Prepaid Forward Contracts

If your uncle, best friend or bank loans you money, is it taxable? Nope, not if it's a real loan. But the loan or income distinction lands many people in trouble with the IRS. Besides, interest rates on risky loans like litigation funding and pre-IPO stock are high, and you might not be able to deduct the interest. Even worse, if a loan is forgiven—even a nonrecourse loan—it is cancellation of debt income (COD). The tax code says not having to pay back a loan is just like cash. How about a sale? If you receive money for selling your stock or assigning half of your expected lawsuit recovery, it is income. Can you get money up front that is not a loan, but that also isn't income when you receive it? The answer to this riddle is yes, with a variable prepaid forward contract. Because the transaction is a sale, you might assume it is taxed now.

However, a *variable* contract leaves open how much money (stock sale proceeds, lawsuit proceeds, etc.) the seller must *later* deliver to the funder. The amount is uncertain because the formula for computing it generally depends on facts that will not be known until the proceeds actually come in. When you sign a prepaid forward contract and receive money, you enter a contract to sell a portion of your stock sale proceeds or lawsuit recovery *later*.

A forward contract calls for a *future* sale. During the time between signing and closing the sale, the upfront cash is like a tax-free deposit. If a prepaid forward contract meets certain requirements, it provides cash to the seller with no immediate tax, just like a loan. However, getting the right documentation is critical. You do not want to enter into a forward contract, pay a funder a steep return, and find out that you must pay taxes *now*.

You also don't want to learn later that you cannot deduct a big payment of proceeds to the funder, or somehow offset it against income from the transaction that generated the proceeds. A prepaid forward contract may involve the sale of stock or other assets. It may involve the assignment of some or all of a lawsuit claim or its proceeds. Many fact patterns are possible with stock sales or litigation finance. But the tax issues are nuanced and can be confusing. A traditional forward contract says the buyer agrees to purchase a fixed quantity of property at a fixed price, payment and delivery to occur on a fixed future date. A "prepaid" forward requires the buyer to pay at the time the parties enter into the contract (as opposed to the delivery date). Taxpayers who sign a forward contract to sell property in the future are generally not treated as having sold the property. The contract remains open, like an option, until it is sold, settled, or lapses.

Money changes hands, but there should be no immediate taxable event to the seller if the future sale involves a *variable* amount of proceeds. Until the closing, it is impossible to determine how the advance payments should be reported. The key IRS tax authority is Revenue Ruling 2003-7, 2003-5 IRB 1, where the IRS approved open transaction treatment for a variable prepaid forward contract involving the sale of stock. The IRS said that no current sale occurred when a shareholder (1) received a fixed amount of cash, (2) simultaneously entered into an agreement to deliver on a future date a number of shares of common stock that varied significantly depending on the value of the shares on the delivery date, (3) pledged the maximum number of shares for which delivery could be required under the agreement, (4) had the unrestricted legal right to deliver the pledged shares or to substitute cash or other shares for the pledged shares on the delivery date, and (5) was not economically compelled to deliver the pledged shares.

Stock Sale? Say Sam enters a prepaid forward contract to sell stock, receiving $100 as an advance. Later, Sam must deliver shares of stock according to a variable formula, or an equivalent value in cash. If Sam physically delivers stock on settlement, Sam will recognize gain or loss based on the difference between $100 and the basis in the stock Sam delivers. If Sam delivers cash, Sam's gain or loss is based on the difference between $100 and the payment made to settle the contract.

Lawsuit Proceeds? Suppose the Plaintiff in a lawsuit enters into a contract to sell F, a litigation funder, 50% of any proceeds he recovers in the case. F pays Plaintiff the purchase price ($100), which might fund legal expenses. Two years later, Plaintiff settles his case for $500. Plaintiff directs the defendant to pay $250 to F as its share of the case proceeds under the contract.

Prepaid forward contracts are legitimate means of generating cash in a tax-efficient way. They are popular in both litigation funding and stock transactions. Deals that stick closely to the pattern set out in Revenue Ruling 2003-7 are best where you can do it. After all, the IRS does not exactly like open transactions where people receive money now but don't pay taxes until later. That means you should be careful with your documents. Ideally, get some tax advice before you sign and also when it comes time for tax reporting.

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