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University of Houston Law Center
Financial Products Taxation
Spring 2026
Course Syllabus

1. **Purpose of this Syllabus.** The purpose of this syllabus is to provide details of how this course will proceed, including what you should expect in terms of readings and during class, how I will grade you, and when I will be available to answer questions you may have.

2. **Introduction, Learning Objectives, and Prerequisites.** The course is perhaps best introduced by posing and answering the following questions:

Why did Compaq Computer Corporation buy 10 million shares of Royal Dutch Petroleum Company worth over $800 million on the New York Stock Exchange, only to trade them back to the seller within the hour? Why did Estée Lauder borrow from her son 5.5 million shares of her company that he then owned, only to sell them in the company's IPO for over $135 million?

The short answer to both these questions is, of course, tax. The long answer to these and other similar questions about seemingly perplexing investor behavior will occupy us in this course on the taxation of financial products—stocks, bonds, calls, puts, and other more exotic derivatives.

At the end of the course, you should have a through grasp of the principles underlying the tax treatment of basic financial instruments, whether those with fixed payoffs or contingent assets, the possible use of these instruments to circumvent the realization requirement and thus defer or even eliminate tax, and the rules and reform proposals designed to curb such practices.

The course should be of interest to students looking at careers in either tax planning or controversy. Transactional lawyers will gain from an understanding of how financial products are sought to be used (or abused) to "optimize" the tax characteristics of income—by recasting, for example, returns on equity as those on debt, or fixed returns as contingent returns, or ordinary income as capital gains, or domestic-source income as foreign-source, and so on. Litigators will acquire an

appreciation of the arguments that do and do not work in preserving these tax characteristics when the IRS challenges the form of the transactions.

The only prerequisite for this course is an introductory course in federal income taxation. I assume no prior knowledge regarding the pricing or taxation of financial products.

3. **Course Materials.** There is no required text or casebook. I will email you all the readings and other assignments. The readings will mostly consist of selected portions of two different treatises: Keyes, Federal Taxation of Financial Instruments & Transactions (Keyes) and Bittker & Lokken, Federal Taxation of Income, Estates & Gifts (B&L), both of which are available on Westlaw, supplemented by extracts from casebooks and corporate finance texts, cases, IRS pronouncements, and journal articles. I will email PDFs of all assigned readings, including those from the two treatises. You will be responsible for looking up the relevant Code and Regulations sections cited in the readings.

4. **Class Sessions, Assignments, and Grading.** The scheduled time for class sessions is 4:00 p.m. to 6:00 p.m., Central time, on **Mondays**, for a total of 14 class sessions. We will meet in synchronous session via Zoom for some or all of that time most weeks. When we are not meeting via Zoom during the scheduled class time, you will be working on "synchronous assignments"—problems that I will email you in real time, which will require you to apply the concepts introduced in the readings.

I will also assign you other "asynchronous problems," on which you will work on your own time. You are welcome to discuss these asynchronous problems amongst yourselves and work on them in groups. You won't be required to turn in solutions to these problems, but I will expect you to come to class prepared to discuss them.

We will spend a lot of our Zoom time discussing the solutions to both the synchronous and asynchronous problems. Your participation in class discussions over the semester will count for half your course grade.

The remaining half of your course grade will reflect your performance on a self-scheduling 24-hour take-home final exam that you can take any time during exam period. That exam will consist of numerical problems a lot like the problems assigned during the semester.

If you are otherwise eligible to do so, you are welcome to exercise the option for receiving a pass/fail grade instead of a quality letter grade.

5. **My Availability.** I will generally be available to answer questions after the end of each class session. You may also make an appointment to meet with me at mutually convenient times. Feel free to contact me by email at ajguptaemail@gmail.com or on my cell at (630) 854-7194.

6. **Counseling Options**. Counseling and Psychological Services (CAPS) can help students who are having difficulties managing stress, adjusting to the demands of a professional program, or feeling sad and hopeless. You can reach CAPS online (www.uh.edu/caps) or by calling (713) 743-5454 during and after business hours for routine appointments or if you or someone you know is in crisis. No appointment is necessary for the "Let's Talk" program, a drop-in consultation service at convenient locations and hours around campus.

7. **Optional Background Materials.** Many standard corporate finance texts provide an excellent introduction to the essential characteristics and standard valuation approaches for most basic financial products. These include Brealey et al., Principles of Corporate Finance, ISBN-13: 978-1259144387, and Ross et al., Fundamentals of Corporate Finance, ISBN-13: 978-0077861704. You are welcome, but are certainly not required, to refer to them to get a better understanding of the underlying economics of these financial products.

8. **Diversity and Inclusion**. I am committed to ensuring an inclusive online learning space, where you will be treated with respect and dignity, regardless of socio-economic status, age, race, ethnicity, disability, religion, national origin, veteran's status, sex, sexual orientation, gender identity or expression, marital status, political, religious, or ideological affiliation, or any other attribute. Diversity of thought is just as valued and important as any immutable diverse characteristic. If you feel like your class performance is impacted in any way by your experiences inside or outside of class, please reach out to me. I want to be a resource for you. If you feel more comfortable speaking with someone besides me, you can call Student Services at (713) 743-2182. Finally, I encourage you to bring any issues negatively impacting UHLC's openness to diversity and inclusion to the Law Center's Diversity and Inclusion (D&I) committee. The D&I committee's charge includes "[building] on the Law Center's strengths as a diverse and inclusive environment." You can contact

the committee directly at UHLCD&I@uh.edu. Your suggestions are encouraged and appreciated. Please let me know ways to improve the effectiveness of this course for you personally, or for other students or student groups.

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Tentative Reading List

I have provided below a tentative list of topics that I intend to cover and outlined most of the readings I will be assigning during the semester. I will periodically amend this list to track our actual progress. If you wish to read ahead, I have indicated the relevant sections from the Keyes and B&L treatises and cited the other readings.

Weeks 1-4: Equity Instruments

Class Session #1: Distinction Between Debt and Equity

Handout on Capital Structure (including the problems on pages 27-28 and 30-31).

Class Session #2: Stock Distributions

Eisner v. Macomber, 252 US 189 (1920).

Keyes ¶¶ 1.01-1.05.

Class Session #3: Dividend Stripping

Keyes ¶¶ 2.01-2.04.
IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir.2001).
Compaq Computer v. Commissioner, 277 F.3d 778 (5th Cir. 2001).

Class Session #4: Short Sales

B&L ¶ 50.3.

Weeks 5-7: Debt Instruments

Class Session #5: Original Issue and Market Discount

Original Issue Discount

B&L ¶¶ 53.1-53.5.

Debt Instruments Issued for Property Disposition

B&L ¶¶ 54.1-54.7.

Market Discount

Keyes ¶¶ 8.01-8.06; ¶¶ 10.01-10.03.

Class Session #6: Variable Rate and Contingent Debt Instruments

Keyes ¶¶ 6.01-6.04; ¶¶ 7.01, 7.06-7.07.

Class Session #7: Coupon Stripping

Helvering v. Horst, 311 US 112 (1940).
Keyes ¶¶ 10.01-10.03.

Weeks 8-9: Options

Class Session #8: Overview of Options and Put-Call Parity Theorem

Brealey et al., Principles of Corporate Finance, pp. 512-560.

Class Session #9: Treatment of Options

Keyes ¶¶ 12.01-12.04.

Week 10: Marking to Market

Class Session #10: Section 1256 Contracts

Keyes ¶¶ 13.01-13.07.

Weeks 11-12: Notional Principal Contracts

Class Session #11: Interest Rate and Commodity Swaps

Keyes ¶¶ 14.01-14.03.

Class Session #12: Total Return Swaps

Notice 97-66.
Industry Directive on Total Return Swaps (Jan. 14, 2010). Notice 2010-46.
JCT, General Explanation of Tax Legislation Enacted in the 111th Congress (March 2011) (extract).
IRS AM 2012-009.

Weeks 13-14: Financial Transactions

Class Session #13: Hedging Transactions and Straddles

B&L ¶¶ 57.5, 57.6.

Class Session #14: Wash Sales and Constructive Sales

B&L ¶ 44.8, 57.8.2.
Rev. Rul. 2003-7, 2003-5 IRB 363.
Anschutz Co. v. Commissioner, 135 TC 78 (2010).

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Financial Products Taxation
Reading #1

Capital Structure

Code: §§ 163(j), 165(g)(1), (2); 166(a), (d), (e); 385; 1244(a)-(c). Skim §§ 1045; 1202. Regulations: §§ 1.165-5(a)-(c); 1.166-5; 1.1244(a)-1(a), (b).

Schwarz and Lathrope, Fundamentals of Corporate Taxation, Cases and Materials, 10th ed. (2019), Chapter 3, Capital Structure (attached).

Problems (reproduced from pages 27-28 and 30-31 of the attached casebook extract).

1. Aristocrat, Baker and Chef have formed Chez Guevara, Inc. ("Chez") as a C corporation to operate a gourmet restaurant and bakery previously operated by Chef as a sole proprietorship. Aristocrat will contribute $80,000 cash, Baker will contribute a building with a fair market value of $80,000 and an adjusted basis of $20,000, and Chef will contribute $40,000 cash and the goodwill from his proprietorship with an agreed value of $40,000 and has a zero basis. In return, each of the parties will receive 100 shares of Chez common stock, the only class outstanding.

Chez requires at least $1,800,000 of additional capital in order to renovate the building, acquire new equipment and provide working capital. It has negotiated a $900,000 loan from Friendly National Bank on the following terms: interest will be payable at two points above the prime rate, determined semi-annually, with principal due in ten years and the loan will be secured by a mortgage on the renovated restaurant building.

Evaluate the following alternative proposals for raising the additional $900,000 needed to commence business, focusing on the possibility that the Service will reclassify corporate debt instruments as equity:

(a) Aristocrat, Baker and Chef each will loan Chez $300,000, and each will take back a $300,000 five-year corporate note with variable interest payable at one point below the prime rate, determined annually.

(b) Same as (a), above except that each of the parties will take back $300,000 of 10% 20-year subordinated income debentures; interest will be payable only out of the net profits of the business.

(c) Same as (a), above, except that the $900,000 loan from Friendly National Bank will be unsecured but personally guaranteed by Aristocrat, Baker and Chef, who will be jointly and severally liable.

(d) Aristocrat will loan the entire $900,000, taking back a $900,000 corporate note with terms identical to those described in (a), above.

(e) Same as (d), above, except that commencing two years after the incorporation, Chez ceases to pay interest on the notes because of a severe cash flow problem.

2. High Technologies, Inc. ("Hi-Tech") is a small semiconductor company owned and operated by Thelma High and Allen Woody. Thelma and Allen formed Hi-Tech as a C corporation three years ago by each contributing $400,000 in exchange for 50 percent of the corporation's common stock. Hi-Tech has been planning a major expansion of its manufacturing facility and has decided to seek outside financing. It recently approached Jennifer Leech about the possibility of her investing $200,000 in Hi-Tech.

After investigating the corporation's financial position, Jennifer has decided to make the investment. Her objectives are to obtain maximum security while at the same time participating in Hi-Tech's potential growth. Jennifer also is concerned about the rapid change in computer technology and would like to plan for the most favorable tax consequences in the unfortunate event that her investment in Hi-Tech becomes worthless. Consider to what extent Jennifer will realize her economic and tax goals if, in the alternative, her investment takes the following forms:

(a) A $200,000 unregistered five-year Hi-Tech note bearing market rate interest.

(b) A $200,000 Hi-Tech registered bond bearing market rate interest.

(c) A $190,000 Hi-Tech registered bond bearing market rate interest and $10,000 for warrants to purchase Hi-Tech common stock at a favorable price.

(d) $200,000 of Hi-Tech common stock.

(e) $200,000 of Hi-Tech convertible preferred stock.

(f) Same as (d), above, except Thelma and Allen originally capitalized Hi-Tech by each contributing $500,000.

(g) Same as (d), above, except Jennifer plans to give the Hi-Tech common stock to her son, Peter, as a wedding gift.

(h) Same as (d), above, except Jennifer and her son, Peter, will purchase the Hi-Tech common stock through Leech Associates, a venture capital partnership.

Schwarz and Lathrope, Fundamentals of Corporate Taxation, Cases and Materials, 10th ed. (2019).

Chapter 3: Capital Structure

A. Introduction

1. Tax Consequences of Debt and Equity

Introduction. The organizers of a business venture face a major decision in planning the capital structure of their company. The simplest method of raising corporate capital is by issuing stock in exchange for contributions of money, property or services. Stock—known as "equity" in corporate finance parlance—may be common or preferred, and either type may be issued in various classes with different rights and priorities as to voting, dividends, liquidations, convertibility, and the like. A corporation also may raise capital by borrowing, either from the same insider group that owns the company's stock or from banks and other outside lenders. Corporate debt typically is evidenced by a variety of instruments including bonds, notes, convertible debentures, and more exotic hybrid securities designed by Wall Street's financial architects. Although both shareholders and creditors contribute capital, their relationship to the corporation is markedly different. As one early case put it, a shareholder is "an adventurer in the corporate business," taking risk and profit from success, while a creditor, "in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into capital when the payment date arrives."[1]

To some extent, decisions concerning the proper mix of debt and equity are made without regard to tax considerations. Most businesses rely on both short and long-term debt to finance their operations. Quite apart from taxes, traditional corporate finance theorists believed that debt financing contributed to a higher rate of investment return. This conventional wisdom did not go unchallenged. In their well-known writings on corporate finance, Professors Modigliani and Miller took the view that, assuming away taxes and other factors, the value of a corporation is unrelated to the amount of debt used in its capital structure.[2] On the other hand, excessive debt has its pitfalls, and CFOs of fiscally conservative public companies may be reluctant to risk insolvency or a shaky credit rating by loading the corporate balance sheet with liabilities.[3] In short, many factors other than taxes affect corporate financing decisions.

Historical Tax Bias in Favor of Corporate Debt Financing. Although the tax system may not always drive financing behavior, it can influence the capital structure of both publicly traded and closely held C corporations. Consider the decision facing A and B, who each plan to invest $100,000 on the formation of closely held Newco, Inc. At first glance, it might seem that issuing any Newco debt to A and B would be a needless exercise. If the investors agree on their respective contributions and the

allocation of ownership and voting power, what difference does it make whether they hold stock, bonds or notes? The answer is often found in the Internal Revenue Code, which distinguishes between debt and equity for tax purposes and historically has tipped the scales in favor of including a healthy dose of debt in a corporation's capital structure. This tax bias toward debt financing has been influential both at the time of formation and on later occasions in a corporation's life cycle.

The principal tax advantage of issuing debt as opposed to equity has been avoidance of the "double tax." Even though most dividends qualify for a preferential tax rate, they still are includible in a shareholder's income and are not deductible by the corporation. The earnings represented by these dividends are thus taxed at both the corporate and shareholder levels.[4] But interest paid on corporate debt, while also includible in the recipient's income, generally has been fully deductible by the corporation.[5]Assuming the owners of the business desire an ongoing return on their investment before a sale, there has been a tax incentive for a corporation to distribute some part of its earnings with tax-deductible dollars.[6] Additionally, the investment return earned by the corporation on the borrowed funds in excess of the cost of borrowing (the interest expense net of tax savings) accrues to the benefit of the shareholders.

Several other features of the tax law also have reflected a bias in favor of debt over equity. The repayment of principal on a corporate debt is a tax-free return of capital to the lender. If the amount repaid exceeds the lender's basis in the debt, the difference generally is treated as a capital gain under Section 1271. In contrast, when a corporation redeems (i.e., buys back) stock from a shareholder—a transaction quite similar to the repayment of a debt—the entire amount received may be taxed as a dividend if the shareholder or related persons continue to own stock in the corporation.[7]

The issuance of debt at the time of incorporation also may provide a defense against subsequent imposition of the accumulated earnings tax.[8] The obligation to repay a debt at maturity may qualify as a "reasonable business need," justifying an accumulation of corporate earnings,[9] while the same type of accumulation for a redemption of stock normally is not regarded as reasonable for purposes of the accumulated earnings tax.[10]

These tax advantages for corporate debt financing are offset, to some degree, by the shareholder-level tax benefits for equity that accrue to taxable shareholders. Dividends received by individual shareholders are taxed at preferential rates and, to the extent corporate profits are accumulated, those shareholders are able to realize their economic gains through stock sales that are advantageously timed and taxed at preferential long-term capital gain rates. Better still, shareholders who hold their stock until death are able pass the stock to their heirs with a fair market value basis under Section 1014. On the other hand, tax-exempt shareholders (e.g., pension funds, wealthy charities, and some foreign investors) would not have the same tax incentives to favor equity, and their presence would tend to strengthen the historical tax bias in favor of corporate debt financing.[11]

The choice between debt and equity also has significant tax ramifications in other contexts. For example, the classification of a corporate investment may have an impact on whether transfers of property to a corporation qualify for nonrecognition under Section 351. Complete nonrecognition of gain or loss is available only when the contributing taxpayer receives solely stock. Conversely, taxpayers who wish to recognize gain on the transfer of property to a controlled corporation may attempt to accomplish their objective by taking back boot in the form of installment debt obligations.[12] That goal will be thwarted if the notes are reclassified as stock. Classification of an interest in a corporation also may control the character of a loss if the investment becomes worthless.[13]

Tax Cuts and Jobs Act Changes Influencing the Tax Choice Between Debt and Equity. The Tax Cuts and Jobs Act made two significant changes to the Code that alter the tax consequences of corporate debt financing: (1) the top corporate income tax rate was reduced from 35 to 21 percent, and (2) a new limitation on the deductibility of business interest was enacted in Section 163(j). Importantly, the new section 163(j) limitation is scheduled to become even more restrictive after 2021.[14] The details and potential impact of Section 163(j) are covered in the next section of this chapter.

The reduction in corporate income tax rates significantly reduces the value of a corporation's tax deduction for interest expense and alters the calculation of the combined corporate and investor after-tax cost of debt and equity for corporations with taxable investors. For example, assume that a corporation has $1,000 of taxable income and one hypothetical investor who is taxable on additional ordinary income at the 37 percent top individual rate (so that qualified dividends are taxable at 20 percent) and also is subject to the 3.8 percent tax on net investment income. If the corporation first pays a 21 percent income tax on its $1,000 of taxable income ($210), it will have $790 to distribute to the investor as a dividend, which would be taxable at 23.8 percent. The investor would owe $188 in tax on the $790 dividend and the combined total tax owed by the corporation and the investor would be $398. Alternatively, assume that the corporation pays the investor the $1,000 as tax deductible interest on its debt obligation to the investor. In that case, there would be no corporate income tax owed as a result of the corporation's interest deduction and the investor would owe a tax of $408 (the combined rate is 40.8 percent, the total of the 37 percent income tax plus the 3.8 percent tax on net investment income). Note that the total corporate and investor tax in the dividend scenario ($398) is less than the total corporate and investor tax in the interest-expense scenario. The example illustrates that at the highest marginal individual income tax rates, the shareholder tax benefits afforded to dividend income can slightly outweigh the benefit of reducing the corporate income tax via tax deductible interest. The broader point is that the reduction in the corporate income tax rate to 21 percent reduces the value of the corporation's deduction for interest expense.

Will the cut in the corporate tax rate to 21 percent and the reduction in the tax benefits of corporate debt lead to a future reduction in debt financing by American corporations? Interestingly, the empirical evidence suggests that past tax law

changes have had no significant effect on changes in the capital structure of publicly traded companies.[15] Some researchers also hypothesize that debt financing is more likely to increase as a result of a tax increase than it is to decrease as a result of tax rate cuts. Theoretical explanations for the expected limited reduction in debt financing after the corporate tax rate cut include: (1) the fact that buying back debt is a cost born by equity holders, while the remaining debt holders benefit as a result of their debt becoming less risky and more valuable; (2) refinancing corporate debt through issuance of additional stock may lead to potential adverse dilution in the value of the corporation's shares; (3) a significant number of faster-growing and smaller public companies are initially under-leveraged and as they grow optimistic managers will prefer to debt finance future growth; and (4) leverage should be measured net of corporate cash and on that basis it is low as a result cash locked up in overseas investments which has become more accessible as a result of international tax changes made by the Tax Cuts and Jobs Act.[16]

In summary, the reduction in the corporate tax rate to 21 percent has no doubt increased corporate cash flow. But the empirical and theoretical research does not seem to support the notion that the tax rate cut alone will significantly change the levels of corporate debt financing by publicly traded companies. Perhaps shareholders in closely held companies will be more responsive to the tax incentives created in the post-Tax Cuts and Jobs Act rate environment. It is early and, no doubt, more evidence of taxpayer behavior will be available in the future.

2. Limitation on Deduction of Business Interest

Code: § 163(j).

Introduction. The Tax Cuts and Jobs Act amended Section 163(j) of the Code to limit the deduction for "business interest" for any taxable year. The limitation was enacted to reduce the tax incentive for debt financing of business activities and to offset some of the revenue costs of the corporate tax rate reduction and other business tax benefits. The House Ways and Means Committee explained the reason for the change:[17]

> The Committee believes that the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system. The effective marginal tax rate on debt-financed investment is lower than that on equity-financed investment. Limiting the deductibility of interest along with reducing the corporate tax rate narrows the disparity in the effective marginal tax rates based on different sources of financing. This leads to a more efficient capital structure for firms.

The Section 163(j) deduction cap is the sum of: (1) business interest income for the taxable year; (2) 30 percent of the taxpayer's "adjusted taxable income;" and (3) the taxpayer's "floor financing interest" (a specialized category for retail car dealers).[18] Business interest disallowed under this provision may be carried forward indefinitely.[19] The new limitation applies to all business taxpayers, not just

corporations, and it is applied after any other limitations, such as those requiring deferral or capitalization of interest expense in certain situations. Special rules, not directly relevant to C corporations, apply to pass-through entities.[20]

"Business interest" is any interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include "investment interest," which continues to be subject to its own set of limitations under Section 163(d). Business interest income is interest income allocable to a trade or business.[21] In the case of a C corporation, virtually all interest income and expense will be allocable to its trade or business activities.

Definition of Adjusted Taxable Income. The key measure for the deduction cap is "adjusted taxable income" ("ATI"), which is defined as the taxpayer's taxable income computed without regard to: (1) tax items not properly allocable to a trade or business; (2) any business interest expense or business interest income; (3) the amount of any net operating loss deduction; (4) the 20 percent deduction provided by Section 199A for certain "qualified business income" from pass-through entities; and (5) for tax years beginning before January 1, 2022, deductions for depreciation, amortization or depletion (this category would include any costs expensed under Sections 168(k) or 179).[22] ATI is thus conceptually similar to what is known in accounting jargon as EBITDA (earnings before interest, taxes, depreciation and amortization), a metric used by financial analysts to measure a company's operating performance without regard to its capital structure, taxes, or cost recovery deductions.

Definition of ATI After Year 2021. Beginning in 2022, ATI is determined without adding back depreciation and amortization so that it resembles EBIT (earnings before interest and taxes). In most cases, the impact of this change is to lower the ceiling (because the cap will be 30 percent of a lower number), further limiting the deduction for business interest. The combination of immediate expensing for equipment and the harsher post-2021 cap has the odd effect of punishing companies that increase their capital investment. This future change in the formula presumably was made to increase the revenue estimates for the "out years" of the relevant budget window rather than for any discernable policy reasons. Thus, there is at least some possibility that the post-2021 change in the ATI formula may be repealed or modified.

Special Relief Provisions. Relief from the business interest deduction limitation is provided for "small businesses," which generally are taxpayers with average annual gross receipts not exceeding $25 million for the three-year period ending with the prior taxable year.[23] An exception also is available, at the taxpayer's election, to a real property trade or business, as broadly defined in Section 469(c)(7)(C) to encompass real estate development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, brokerage trade or business, and (according to the legislative history) operation or management of a lodging facility.[24] The trade-off for taxpayers who make this election is that they must use the slightly slower alternative depreciation system under Section 168(g), which requires straight line cost recovery over 30 years for residential rental property

(instead of 27.5 years) and 40 year for commercial property (instead of 39 years). Real estate businesses will need to do a cost/benefit analysis in deciding whether or not to make this election. Similarly, at the taxpayer's election, any farming business and certain agricultural or horticultural cooperatives, will not be subject to the Section 163(j) interest deduction limitation.[25]

The introduction of a limitation on the deduction of business interest may be one of the most profound changes made by the Tax Cuts and Jobs Act because of importance of debt financing in business activities. The IRS has issued extensive proposed regulations interpreting various aspects of the Section 163(j) limitation on business interest.[26] Those proposed regulations: (1) define "business interest" expansively; (2) explain how the business interest limitation interacts with other provisions of the Code, including deduction limitations; (3) clarify the statutory definition of adjusted taxable income and provide the other adjustments authorized by § 163(j)(8)(B); (4) address specialized situations, such as the treatment of partnerships and S corporations and application of the limitation to affiliated groups of domestic corporations, foreign corporations, and other foreign persons with income effectively connected to a U.S. trade or business; and (5) much more. The proposed regulations also make it clear that the business interest limitation rules of § 163(j) have no effect on a corporation's earnings and profits.[27]

The "big question" is how many corporations will actually be subject to the Section 163(j) limitation and whether firms will modify their capital structures in response to the provision. Researchers have examined the public financial information of 333 companies in the S&P 500 over fiscal years 2007–2017 to gauge the potential impact of Section 163(j). The sample excluded companies in the financial services, real estate, and public utilities industries.[28] Based on the financial statement data, it appeared that about five percent of the corporations would face the Section 163(j) limitation at some time during the period of 2018 through 2021, when the more generous limitation applies. Beginning in 2022, the researchers estimate that a significant number of companies may be subject to the limitation. In fact, 105 of the 333 corporations potentially would have exceeded the EBIT limit at least once between 2007 and 2017, and 26 of the corporations would have exceeded that limit six or more times during that time period.[29] The researchers also focused more specifically on the financial data of those 26 corporations and found many are in the process of adjusting their debt structures. Some of those taxpayers have pre-2017 net operating losses which can be used to offset 100 percent of taxable income in future years, thereby allowing more time to make changes in their capital structures. The other corporations in the 26 "at risk" group appear to be following various strategies to lower interest expense, including (1) issuing new debt at lower interest rates to retire higher rate debt obligations, and (2) retiring debt with cash flow or through newly issue equity.[30] This research indicates that Section 163(j) will modify the future behavior of corporations in danger of exceeding its limitation on the deductibility of business interest.

3. Other Limitations on the Corporate Interest Deduction

At times in the past, Congress has turned its attention to the issue of excessive corporate debt, but these sporadic efforts generally were cautious and limited. Instead of devising a comprehensive solution like Section 163(j), the typical legislative response was a narrowly targeted set of limitations aimed at particular perceived abuses, accompanied by a delegation to the Treasury to elaborate through regulations. This "rifle-shot" approach produced a laundry list of special provisions which taxpayers also must successfully navigate in order to secure a deduction for interest expense. A summary of some of the key provisions follows.

Limitation on Certain Acquisition Indebtedness. Section 279 disallows a deduction for interest on "corporate acquisition indebtedness" in excess of $5 million. Corporate acquisition indebtedness generally is debt incurred to acquire either stock in another corporation, or two-thirds of the assets of another corporation, where (1) the debt is subordinated, (2) the debt is convertible to equity or otherwise carries a feature to acquire equity of the issuer, and (3) the issuer is either thinly capitalized (a debt-equity ratio in excess of 2 to 1) or its projected earnings do not exceed three times annual interest costs.[31] Section 279 contains various excepted transactions, including acquisitions of less than five percent of the stock of another corporation, nontaxable transactions where there is already 80 percent control of the target, and acquisitions of foreign corporations.[32] More importantly, Section 279 does not apply to debt issued to acquire stock of the issuing corporation (e.g., a leveraged share buyback) and can easily be avoided by failing to satisfy the definition of "corporate acquisition indebtedness," such as the requirement that the debt be convertible into equity or include an equity feature.

Applicable High-Yield Discount Obligations. One object of congressional scrutiny was a type of high-yield debt instrument that does not currently pay interest in cash to the lender. This type of junk bond is usually structured as a zero-coupon instrument with an issue price that is significantly lower than the stated redemption price at maturity.[33] The "spread" between the issue and redemption price is "original issue discount" ("OID"). In general, the issuer of an OID bond accrues and deducts the "spread" as interest over the life of the bond even though the interest is not actually paid until maturity, and the lender (even if a cash basis taxpayer) includes OID in income over the life of the bond.[34]

A sensible solution would have been to treat high-yield zero coupon bonds as preferred stock on the theory that their high level of risk and dependence on the profitability of the business causes them to more resemble equity than debt. The legislation ultimately enacted[35] did not go that far. Instead, Congress decided to defer (and in some cases disallow) the issuer's deduction until interest is actually paid in cash but continue to require the lender to recognize interest income as it accrues. This approach represented a congressional willingness to bifurcate certain hybrid securities into debt and equity components. The theory is that a portion of the return on certain junk bonds represents a distribution of corporate earnings with respect to an equity interest in the corporation and should be treated as such for tax purposes.

The restrictions in Section 163(e)(5) apply to an "applicable high-yield discount obligation," which is defined in Section 163(i)as an instrument with: (1) a more than five-year maturity, (2) a yield to maturity that is five percentage points or more than the applicable federal rate in effect for the month in which the obligation is issued, and (3) "significant original issue discount."[36] The OID amount on these bonds is divided between an interest element that is deductible but only when interest is actually paid,[37] and a return of equity element ("the disqualified portion") for which no interest deduction is allowed but which may be eligible for the dividends received deduction in the case of a corporate lender.[38] This approach is a compromise between deferral and total disallowance of the issuer's interest deduction. An instrument generally will have a "disqualified portion" of OID and thus face disallowance of part of the interest deduction if it has significant OID and the yield on the instrument is more than six percentage points over the applicable federal rate.[39]

Interest Paid on Disqualified Debt Instrument. Section 163(*l*) generally disallows a deduction for interest or OID on a debt instrument which is payable in equity of the issuer or a related party or equity held by the issuer or a related party. This type of "payment-in-kind" bond also offered the possibility of a current interest deduction without a cash expenditure. Debt generally is considered payable in equity only if a substantial amount of the principal or interest is either (1) required to be paid or converted into such equity, or (2) is required to be determined by reference to such equity.[40] Note that section 163(*l*) only disallows the issuer's interest deduction. The holder still recognizes income as interest amounts are paid or accrued.

Information Reporting. Section 6043(c) requires information reporting to the IRS. when (1) control (as defined in Section 304(c)(1)) of a corporation is acquired in any transaction, or (2) there is a recapitalization of a corporation or other substantial change in the capital structure of a corporation. The regulations generally limit the reporting requirement to situations where the fair market value of the stock acquired is $100 million or more, and changes in capital structure where the cash and fair market value of property provided to shareholders is $100 million or more.[41]

B. Debt vs. Equity

1. Common Law Standards

Taxpayers have considerable flexibility to structure corporate instruments as debt or equity. In view of the sharply disparate tax treatment of debt and equity, it is hardly surprising that the Service may be unwilling to accept the taxpayer's label as controlling.[42] Form would be elevated over substance if every piece of paper embossed with a corporate seal and bearing the label "debt" were treated as such for tax purposes. To prevent tax avoidance through the use of excessive debt, the Service may recast a purported debt obligation as equity. The tax consequences of a recharacterization can be extremely unpleasant. An interest payment becomes a dividend and the corporation loses its deduction. If and when the note is repaid, the "creditor" finds himself in the role of shareholder, and the "loan repayment" may turn into a taxable dividend instead of a tax-free return of capital.

It is one thing to list the advantages of debt and identify the unfortunate ramifications of reclassification. It is quite another to describe with any precision the process employed by the courts and the Service to determine whether a particular instrument is debt or equity. The case law first approaches the issue by describing a spectrum. At one end is equity, a risk investment with the potential to share in corporate profits. At the other end is debt, evidenced by the corporation's unconditional promise to pay back the contributed funds, with market rate interest, at a fixed maturity date. A pure equity investor—the shareholder—has voting rights and upside potential. A pure debt holder—the creditor—is an outsider with no prospect of sharing in the growth of the enterprise. Many classification controversies involve "hybrid securities" having features common to both debt and equity, and the courts must decide whether these instruments falling in the middle of the spectrum are closer to one end or the other.

Any process that looks at something decidedly gray and tries to determine whether it more closely resembles black or white is bound to be frustrating. And so it is here. The litigated cases are legion and the court decisions have been aptly vilified as a "jungle"[43] and a "viper's tangle."[44] The issue is murky because classification of an obligation as debt or equity traditionally is treated as a question of fact to be resolved by applying vague standards that require the weighing of many factors.[45] In a manner reminiscent of the approach to determining whether an asset is "held primarily for sale to customers," the courts have spewed forth laundry lists of "factors," but it is difficult to discern which are controlling in a given case. Exhaustive research leaves one with the firm conviction that the courts are applying an amorphous and highly unsatisfactory "smell test."

Synthesizing the decisional morass is a perilous enterprise, but the principal factors enunciated by the courts over the years may be summarized as follows:[46]

Form of the Obligation. Labels are hardly controlling, but the decisions provide some guidance for a corporation that wishes to avoid reclassification of debt as equity. At a minimum, debt instruments should bear the usual indicia of debt—an unconditional promise to pay; a specific term; remedies for a default; and a stated, reasonable rate of interest, payable in all events.[47] Equity characteristics should be avoided. For example, the likelihood of reclassification is far greater with a hybrid instrument that makes payment of interest contingent on earnings or provides the holder with voting rights.[48]

The Debt/Equity Ratio. The debt/equity ratio of a corporation is the ratio of the company's liabilities to the shareholders' equity. The ratio has long been used as a tool to determine whether a corporation is thinly capitalized. Thin capitalization, in turn, creates a substantial risk that what purports to be debt will be reclassified as equity on the theory that no rational creditor would lend money to a corporation with such nominal equity.

The trouble with this attempt at quantification is that the cases are inconsistent as to what constitutes an excessive debt/equity ratio. For example, depending on all the other factors, a debt/equity ratio of 3-to-1, which most would regard as

conservative, has been held to be excessive,[49] while ratios of 50-to-1 and higher have been held to be acceptable.[50] Some cases apply different norms for different industries,[51] others ignore the ratio entirely,[52] and some evaluate the ratio in the context of the overall growth prospects of the business.[53]

And how is the debt/equity ratio to be computed? Consider some of the basic questions on which there has been disagreement. Is debt limited to shareholder debt or does it include debts to outsiders?[54] Does outside debt include accounts payable to trade creditors or only long-term liabilities? What about shareholder guaranteed debt?[55] In determining "equity," are assets taken into account at their book value (i.e., adjusted basis) or fair market value?[56] The differences in approach can be considerable.

Intent. Some cases have turned on the "intent" of the parties to create a debtor-creditor relationship.[57] "Intent" presumably is not gleaned by a subjective inquiry; it would be meaningless to place the corporate insiders on the witness stand and ask whether they "intended" to be shareholders or creditors. The more reasoned decisions measure "intent" by objective criteria such as the lender's reasonable expectation of repayment, evaluated in light of the financial condition of the company, and the corporation's ability to pay principal and interest.[58] Hindsight also plays a role. For example, if the corporation consistently fails to pay interest or repay debts when they are due, its claim to debtor status may be highly questionable.[59]

Proportionality. In a closely held setting, debt held by the shareholders in the same proportion as their stock holdings normally raises the eyebrows of the Service.[60] The rationale is that if debt is held in roughly the same proportion as stock, the "creditors" have no economic incentive to act like creditors by setting or enforcing the terms of the so-called liability. The unanswered question is whether proportionality, without other negative factors, is sufficient in itself to convert the obligation into stock.[61]

Subordination. If a corporation has borrowed from both shareholders and outside sources, the independent creditors frequently will require that the shareholder debt be subordinated to the claims of general creditors. Although subordination of inside debt would appear to be inevitable if significant unsecured outside financing is desired, some courts have regarded it as the smoking pistol.[62] Once again, however, it is difficult to advise a client with any certainty that subordination is fatal per se. The economic realities of closely held corporate life would suggest that it should not be determinative, but it grows in importance when combined with other negative factors such as thin capitalization, proportionality, and failure to pay any dividends.[63]

This distillation of factors barely scratches the surface. The *Indmar Products* case, which follows, provides an illustration of one court's approach to the problem.

Indmar Products Co., Inc. v. Commissioner

United States Court of Appeals, Sixth Circuit, 2006.

444 F.3d 771.

■ McKeague, Circuit Judge.

Indmar Products Co., Inc. ("Indmar") appeals the decision of the Tax Court to disallow interest deductions the company claimed for tax years 1998–2000, and to assess accuracy-related tax penalties for those years. The interest deductions relate to a number of advances made to Indmar by its majority stockholders over several years. Indmar argued at trial that the advances were legitimate loans made to the company, and thus it could properly deduct the interest payments made on these advances under 26 U.S.C. § 163(a). The Tax Court, following the position taken by the Commissioner of Internal Revenue (the "Commissioner"), disagreed, concluding that the advances were equity contributions and therefore the company could not deduct any purported interest payments on these advances. The court imposed penalties on Indmar based on the deductions. * * *

Upon review of the record, we conclude that the Tax Court clearly erred in finding the advances were equity. The Tax Court failed to consider several factors used by this court for determining whether advances are debt or equity, ignored relevant evidence, and drew several unsupported inferences from its factual findings. We reverse and find that the stockholder advances were bona fide debt.

I. BACKGROUND

A. Stockholder Advances to Indmar

Indmar, a Tennessee corporation, is a marine engine manufacturer. In 1973, Richard Rowe, Sr., and Marty Hoffman owned equal shares of Indmar. In 1987, after Hoffman passed away, Richard and his wife, Donna Rowe, together owned 74.44% of Indmar, with their children and children's spouses owning the rest. By all accounts, Indmar has been a successful company. From 1986 to 2000, Indmar's sales and costs-of-goods sold increased from $5m and $3.9m to $45m and $37.7m, respectively. In addition, Indmar's working capital (current assets minus current liabilities) increased from $471,386 to $3.8m. During this period, Indmar did not declare or pay formal dividends.

Since the 1970s, Indmar's stockholders have advanced funds to it, receiving a 10% annual return in exchange. Hoffman started the practice in the 1970s. Beginning in 1987, the Rowes (as well as their children) began to make advancements on a periodic basis. Indmar treated all of the advances as loans from stockholders in the corporate books and records, and made monthly payments calculated at 10% of the advanced funds. Indmar reported the payments as interest expense deductions on its federal income tax returns. Consistent with Indmar's reporting, the Rowes reported the payments as interest income on their individual income tax returns.

The parties did not initially document the advances with notes or other instruments. Beginning in 1993, the parties executed notes covering all of the

advances at issue. Specifically, Indmar executed a promissory note in 1993 with Donna Rowe for $201,400 (i.e., her outstanding balance). The note was payable on demand and freely transferable, had no maturity date or monthly payment schedule, and had a fixed interest rate of 10%. In 1995, Indmar executed a similar promissory note with Richard Rowe for $605,681 (i.e., his outstanding balance). In 1998, when the outstanding transfers totaled $1,222,133, Indmar executed two line of credit agreements with the Rowes for $1m and $750,000. The line of credit agreements provided that the balances were payable on demand and the notes were freely transferable. In addition, the agreements provided a stated interest rate of 10% and had no maturity date or monthly payment schedule. None of the advances were secured.

Repayments of the advances were paid on demand, based on the needs of the stockholders, and not subject to set or predetermined due dates. The record indicates that between 1987 and 2000, the total advance balances ranged from $634,000 to $1.7m, and Indmar made purported interest payments between $45,000 and $174,000 each year.

The parties structured the advances as demand loans to give the Rowes flexibility as creditors. Moreover, as demand loans, the advances were treated by the Rowes as short-term debt under Tennessee law, thereby excepting interest payments from a 6% state tax on dividends and interest on long-term debts. * * * Indmar, however, reported the advances as long-term liabilities on its financial statements to avoid violating loan agreements with First Tennessee Bank ("FTB"), its primary creditor, who required a minimum ratio of current assets to current liabilities.

In order to reconcile the treatment and execution of the advances as demand loans versus listing them as long-term debt in its financial reports, Indmar received waivers from the Rowes agreeing to forego repayment on the notes for at least 12 months. From 1989 to 2000, the notes to Indmar's financial statements disclosed that "The stockholders have agreed not to demand payment within the next year," and in 1992 and 1993, the Rowes signed written agreements stating that they would not demand repayment of the advances. Indmar did all of this under the direction of its accountant.

Despite the annual waivers, the Rowes demanded and received numerous partial repayments of the advances. Specifically, in 1994 and 1995, Richard Rowe demanded repayment of $15,000 and $650,000, respectively, to pay his taxes and purchase a new home. He also demanded repayment of $84,948, $80,000, $25,000, and $70,221 from 1997–2000 to pay litigation expenses, boat repairs, and tax expenses. Donna Rowe demanded repayment of $180,000 in 1998 for boat repairs. The Rowes made additional advances in 1997 and 1998 of $500,000 and $300,000, respectively. The balance of notes payable to stockholders on December 31, 2000, totaled $1,166,912.

As Indmar was a successful, profitable company, numerous banks sought to lend money to it. FTB worked hard to retain Indmar's business, made funds immediately available upon request, and was willing to lend Indmar 100% of the stockholder advances.

In its loan agreements with Indmar, FTB required the company to subordinate all transfers, including stockholder advances, to FTB's loans. FTB did not strictly enforce the subordination provision, however, as Indmar repaid—with FTB's knowledge—some of the stockholder advancements at the same time FTB loans remained outstanding. As an example, when Richard demanded repayment of $650,000 to purchase a new home, Indmar borrowed the entire amount from FTB at 7.5% (the prime lending rate was 8.75%). Indmar secured the loan with inventory, accounts and general intangibles, equipment, and the personal guarantee of the Rowes. Richard Moody, the FTB lending officer who worked with Indmar on the loan, testified that he knew Indmar used the proceeds to repay Richard. Indmar had loans outstanding with FTB at the time.

As stipulated by the parties, the prime lending rate ranged from a low of 6% to a high of 10.5% between 1987–1998. In 1997, Indmar and FTB executed a promissory note for $1m that was modified in 1998. The interest rate on the note (7.85%) was below the prime lending rate. Indmar also had a collateralized line of credit with FTB. Similar to the stockholder advances, the bank line of credit was used for short-term working capital. FTB charged the following rates for the secured line of credit [from 1995 to 2000, the rates ranged from 8 to 9.5 percent. Ed.]:

B.Claimed Deductions at Issue

On its tax returns for 1998–2000, Indmar claimed deductions for the purported interest payments paid on the stockholder advances. The Commissioner issued a notice of deficiency. Indmar filed a petition in the Tax Court challenging the Commissioner's decision. After trial, the Tax Court concluded that the advances did not constitute genuine indebtedness and thus the payments to the stockholders were not deductible. The Tax Court calculated a total tax deficiency of $123,735 and assessed $24,747 in penalties. Indmar timely appealed.

II. LEGAL ANALYSIS

A. Determining Whether Advance Is Debt or Equity.

* * * The basic question before us is whether the advances made to the company by the stockholders were loans or equity contributions. Under 26 U.S.C. § 163(a), a taxpayer may take a tax deduction for "all interest paid or accrued . . . on indebtedness." There is no similar deduction for dividends paid on equity investments. Thus, if the advances were loans, the 10% payments made by Indmar to the Rowes were "interest" payments, and Indmar could deduct these payments. If, on the other hand, the advances were equity contributions, the 10% payments were constructive dividends, and thus were not deductible.

Over the years, courts have grappled with this seemingly simple question in a wide array of legal and factual contexts. The distinction between debt and equity arises in other areas of federal tax law, see, e.g., Roth Steel Tube Co. v. Comm'r, 800 F.2d 625, 629–30 (6th Cir.1986) (addressing the issue in the context of the deductibility of advances as bad debt under 26 U.S.C. § 166(a)(1)), as well as bankruptcy law * * * The Second Circuit set out the "classic" definition of debt in Gilbert v. Commissioner: "an unqualified obligation to pay a sum certain at a

reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." 248 F.2d 399, 402 (2d Cir.1957). "While some variation from this formula is not fatal to the taxpayer's effort to have the advance treated as a debt for tax purposes, . . . too great a variation will of course preclude such treatment." Id. at 402–03. The question becomes, then, what is "too great a variation"?

To determine whether an advance to a company is debt or equity, courts consider "whether the objective facts establish an intention to create an unconditional obligation to repay the advances." * * * In doing so, courts look not only to the form of the transaction, but, more importantly, to its economic substance. See, e.g., Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir.1968) ("The various factors . . . are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship."); Byerlite Corp. v. Williams, 286 F.2d 285, 291 (6th Cir.1960) ("In all cases, the prevailing consideration is that artifice must not be exalted over reality, whether to the advantage of the taxpayer, or to the government.").

The circuit courts have not settled on a single approach to the debt/equity question. We elucidated our approach in *Roth Steel,*setting out eleven non-exclusive factors for courts to consider:

> (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.

800 F.2d at 630. No single factor is controlling; the weight to be given a factor (if any) necessarily depends on the particular circumstances of each case. * * *

B. Standard of Review

We review the Tax Court's factual findings for "clear error" and its application of law de novo. * * * The circuits are split on whether the debt/equity question is one of fact or law, or a mixed question of fact and law. * * * Earlier panels of this court have held that the question is one of fact. * * * Accordingly, we review the Tax Court's findings for clear error.

With these principles in mind, we now turn to the Tax Court's decision in this case.

C. *Roth Steel* Factors

After discussing some, but not all, of the *Roth Steel* factors, the Tax Court concluded that the Rowes' advances were equity contributions. Specifically, it found the following factors weighed in favor of equity: (i) Indmar did not pay any formal dividends (although this is not one of the Roth Steel factors); (ii) there was no fixed maturity date or obligation to repay; (iii) repayment came from corporate profits and would not be paid if there were not sufficient profits; (iv) advances were unsecured; (v) there was no sinking fund; and (vi) at the time advances were made, there was no unconditional and legal obligation to repay. The court found that several factors weighed in favor of debt: (i) Indmar reported the advances on its federal income tax returns as interest expenses; (ii) external financing was available; (iii) Indmar was adequately capitalized; (iv) the advances were not subordinated to all creditors; and (v) the Rowes did not make the advances in proportion to their respective equity holdings. The court concluded that the factors favoring equity certainly outweigh those favoring debt. * * * As explained below, we find that the Tax Court clearly erred in concluding that the advances were equity contributions rather than bona fide debt. The Tax Court failed to consider several Roth Steel factors. It also did not address in its analysis certain uncontroverted testimony and evidence upon which the parties stipulated. Consideration of all of the record evidence in this case leaves us "with the definite and firm conviction that a mistake has been committed." Holmes, 184 F.3d at 543.

1. Fixed Rate of Interest and Interest Payments

The first factor to which we look is whether or not a fixed rate of interest and fixed interest payments accompanied the advances. * * * The absence of a fixed interest rate and regular payments indicates equity; conversely, the presence of both evidences debt. * * * In its findings of fact, the Tax Court determined that the advances were made with a 10% annual return rate. The court also found that Indmar made regular monthly interest payments on all of the advances. The fixed rate of interest and regular interest payments indicate that the advances were bona fide debt. In its analysis, however, the Tax Court took a different view. Rather than analyzing these facts within the Roth Steel framework (i.e., as objective indicia of debt or equity), the Tax Court focused instead on why the Rowes made the advancements: it concluded that the Rowes "characterized the cash transfers as debt because they wanted to receive a 10-percent return on their investment and minimize estate taxes." * * * Yet, neither of these intentions is inconsistent with characterizing the advances as loans.

For tax purposes, it is generally more important to focus on "what was done," than "why it was done." United States v. Hertwig, 398 F.2d 452, 455 (5th Cir.1968). "In applying the law to the facts of this case, . . . it is 'clear that the objective factors . . . are decisive in cases of this type.' " Raymond, 511 F.2d at 191 (quoting Austin Village, 432 F.2d at 745). It is largely unremarkable that the Rowes wanted to receive a return from their advances. Most, if not all, creditors (as well as equity investors) intend to profit from their investments. Bordo Prods. Co. v. United States, 201 Ct.Cl.

482, 476 F.2d 1312, 1322 (1973). As long as the interest rate is in line with the risks involved, a healthy return on investment can evidence debt.

Of course, "[e]xcessively high rates would . . . raise the possibility that a distribution of corporate profits was being disguised as debt. Were such the purpose of an exorbitant interest rate, the instrument involved would probably not qualify as debt in form." Scriptomatic, Inc. v. United States, 555 F.2d 364, 370 n. 7 (3d Cir.1977) (citing William T. Plumb, Jr., The Fed. Income Tax Significance of Corporate Debt: A Critical Analysis & A Proposal, 26 Tax L.Rev. 369, 439–40 (1971)). The Tax Court found that the 10% rate exceeded the federal prime interest rate during most of the period at issue, as well as the rate charged by FTB on several of its loans to Indmar.

The record indicates that the 10% rate was not an "exorbitant interest rate" under the circumstances. Indmar had a collateralized line of credit with FTB, which, similar to the stockholder advances, was available for short-term working capital. The rate charged by FTB for the line of credit ranged between 8%–9.5%, a rate not much below the fixed rate of 10% charged by the Rowes. The rate differential makes financial sense when considering the differences in security—the FTB line of credit was secured while the Rowes' advances were not.[2]

As for the Rowes' desire to minimize their estate taxes, this also offers little to the analysis. "Tax avoidance is entirely legal and legitimate. Any taxpayer 'may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.' " * * * The desire to avoid or minimize taxes is not itself directly relevant to the question whether a purported loan is instead an equity investment. Rather, such a desire is only tangentially relevant, by acting as a flag to the Commissioner and courts to look closely at the transaction for any objective indicia of debt.

Far from proving the Commissioner's position, the existence and consistent payment of a fixed, reasonable interest rate strongly supports the inference that the advances were bona fide loans.

2. Written Instruments of the Indebtedness

"The absence of notes or other instruments of indebtedness is a strong indication that the advances were capital contributions and not loans." * * * In its analysis, the Tax Court found that Indmar "failed to establish that, at the time the transfers were made, it had the requisite unconditional and legal obligation to repay the Rowes (e.g., the transfers were not documented)." * * *

The Tax Court focused on only half the story. For years 1987–1992, the Rowes did make advancements without executing any notes or other instruments. Beginning in 1993, and for all the tax years at issue in this case, the parties executed notes of loans and lines of credit covering all of the advances at issue, as the Tax Court noted in its findings of fact. Yet, in its analysis of the Roth Steel factors, the Tax Court was silent as to the subsequent execution of notes. After-the-fact consolidation of prior advances into a single note can indicate that the advances were

debt rather than equity contributions. * * * The Tax Court erred by focusing on the initial lack of documentation without addressing the subsequent history of executed notes.

3.Fixed Maturity Date and Schedule of Payments

"The absence of a fixed maturity date and a fixed obligation to repay indicates that the advances were capital contributions and not loans." * * * Based on the Rowes' waivers, the Tax Court concluded that there was no fixed maturity date or fixed obligation to repay. While correct, we find that this factor carries little weight in the final analysis. The parties structured the advances as demand loans, which had ascertainable (although not fixed) maturity dates, controlled by the Rowes. * * * Furthermore, the temporary waiver of payment does not convert debt into equity "since [the stockholders] still expected to be repaid." * * * Where advances are documented by demand notes with a fixed rate of interest and regular interest payments, the lack of a maturity date and schedule of payments does not strongly favor equity. To give any significant weight to this factor would create a virtual per se rule against the use of demand notes by stockholders, even though "[m]uch commercial debt is evidenced by demand notes." * * *

4. The Source of Repayments

"An expectation of repayment solely from corporate earnings is not indicative of bona fide debt regardless of its reasonableness." * * * Repayment can generally come from "only four possible sources . . . : (1) liquidation of assets, (2) profits from the business, (3) cash flow, and (4) refinancing with another lender." * * * The Tax Court found that the "source of repayments" factor favored equity. It relied upon Richard Rowe's testimony that Indmar was expected to make a profit and that repayment "has to come from corporate profits or else the company couldn't pay for it." * * * The full colloquy from the testimony, however, is more equivocal:

Q.. . . [A]t the time that you made these advances, were you anticipating that the repayment was going to come from corporate profits?

A.Yes, sir. It has to come from corporate profits or else the company couldn't pay for it. Unless it made profit—and I have always believed from the first day we started, that we were going to be profitable.

Q.Was it your understanding and intent, at the time you made these advances, that if the company was not, in fact, profitable, you would not be repaid?

A.I had no intentions of not being repaid, sir.

Q.Why is that?

A.I believe it's me. It's my personality.

Q.Is that because you intended to make a profit?

A.Yes, sir.

There are at least two plausible ways to read this testimony. One can read it the way the Tax Court apparently did—Rowe's testimony was, at best, contradictory: repayment must come from profits, but he had no intention of not being repaid,

regardless of the company's fortunes. Given the apparent contradiction, one should focus on the statement against Indmar's interest: Rowe admitted that repayment of the advances "has to come from corporate profits or else the company couldn't pay for it." If repayment "has" to come from profits, then this would imply that repayment was tied to the company's fortunes, suggesting the advances were equity contributions.

Another way to read the testimony, however, is that Rowe, as a small businessman and unsecured creditor, believed that full repayment of all of Indmar's debt required a thriving, successful business, which, ultimately, required profits. In other words, struggling companies near or at bankruptcy do not repay their debts, at least not dollar for dollar. Under this reading, his testimony is consistent with debt. * * *

If there was no other evidence to support one view or the other, we could not say that the Tax Court's reading was clearly erroneous. Credibility determinations are left to the fact finder, and our review on appeal is strictly limited. The "Tax Court 'is not bound to accept testimony at face value even when it is uncontroverted if it is improbable, unreasonable or questionable.' " Lovell & Hart, Inc. v. Comm'r, 456 F.2d 145, 148 (6th Cir.1972) (quoting Comm'r v. Smith, 285 F.2d 91, 96 (5th Cir.1960)). On the other hand, the Tax Court cannot ignore relevant evidence in making its factual findings and any inferences from those findings.

Here, there is undisputed testimony by Rowe and the FTB lending officer, corroborated by stipulated evidence in the record, that clearly weighs in favor of debt on this factor. Indmar repaid a significant portion of the unpaid advances—$650,000—not from profits but by taking on additional debt from FTB. While the interest rate on the FTB loan was lower than 10%, Indmar had to secure the bank loan with inventory, accounts and general intangibles, equipment, and personal guarantees. Thus, Indmar repaid a significant portion of the unsecured stockholder advancements by taking on secured debt from a bank, rather than by taking the funds directly from earnings. This is important evidence that the parties had no expectation that Indmar would repay the advances "solely" from earnings. The Tax Court did not discuss or even cite this evidence in its Roth Steel analysis.

5. The Extent to Which the Advances Were Used to Acquire Capital Assets

Nor did the Tax Court address whether Indmar used the advances for working capital or capital expenditures. "Use of advances to meet the daily operating needs of the corporation, rather than to purchase capital assets, is indicative of bona fide indebtedness." * * * Richard Rowe testified that Indmar always went to a bank for funds to buy capital equipment. He also testified that all of the advances he made to Indmar were used for working capital, as opposed to capital equipment. This is uncontroverted testimony. The government points, however, to Rowe's testimony that he advanced funds even when Indmar did not "need" the funds, and argues that this somehow cuts against his testimony that the advances were used as working capital. The government's argument is unpersuasive. We do not find that Rowe's testimony on this subject was "improbable, unreasonable or questionable," especially in the

absence of the Tax Court addressing this factor in its analysis.[5] A review of Indmar's financial statements shows that it used all of the funds it received in various ways, including working capital and capital equipment expenditures. Thus, Indmar used the advances it received from the Rowes, even if not immediately upon receipt—i.e., Indmar identified a "need" for the advances at some point. There is nothing specific in the record, including Indmar's financial statements, that suggests the advances went to purchase capital equipment as opposed to being used for working capital. Accordingly, the government's supposition does not counter Rowe's testimony, and this factor squarely supports a finding of debt.

6. Sinking Fund

"The failure to establish a sinking fund for repayment is evidence that the advances were capital contributions rather than loans." Id. The Tax Court was correct to point out that the lack of a sinking fund favors equity. This factor does not, however, deserve significant weight under the circumstances. First, a sinking fund (as a type of reserve) is a form of security for debt, and the Tax Court also counted the general absence of security for the stockholder advances as favoring equity. Second, the presence or absence of a sinking fund is an important consideration when looking at advances made to highly leveraged firms. In that case, the risk of repayment will likely be high on any unsecured loans, so any commercially reasonable lender would require a sinking fund or some other form of security for repayment. Where a company has sound capitalization with outside creditors ready to loan it money (as here), there is less need for a sinking fund. * * * .

7. The Remaining *Roth Steel* Factors

On the remaining *Roth Steel* factors, the Tax Court determined that one favored equity (lack of security for the advances) and four favored debt (the company had sufficient external financing available to it; the company was adequately capitalized; the advances were not subordinated to all creditors; and the Rowes did not make the advances in proportion to their respective equity holdings). These findings are well-supported in the record.

8. Failure to Pay Dividends

The Tax Court included in its discussion of *Roth Steel* a factor not actually cited in that case—Indmar's failure to pay dividends. In support, the Tax Court cited our decision in Jaques v. Commissioner. The relevance of Jaques to this case is questionable. That case involved the withdrawal of funds by a controlling stockholder from his closely-held corporation. The stockholder argued that the withdrawal itself was a loan. We rejected the argument, relying in part on the fact that the corporation had never issued a formal dividend, and thus the withdrawal could have been a disguised dividend. Jaques, 935 F.2d at 107–08. The situation here is the exact opposite—the stockholders were advancing money to the corporation (not from), and it is the nature of those advances that we must determine.

Had the Rowes charged Indmar an exorbitant interest rate, the lack of any formal dividends might have been relevant to showing that the payments were not interest payments, but disguised dividends. As this was not the case, see supra Section II.C.1,

we do not address further the relevance, if any, of the lack of dividend payments to the debt/equity question presented here.

D. The Tax Court Committed Clear Error

To summarize, eight of the eleven Roth Steel factors favor debt. The three remaining factors suggest the advances were equity, but, as we explained above, two of the factors—the absence of a fixed maturity date and schedule of payments and the absence of a sinking fund—deserve little weight under the facts of this case. Moreover, the non-Roth Steel factor relied upon by the Tax Court—Indmar's failure to pay dividends—has questionable relevance to our inquiry. The only factor weighing in favor of equity with any real significance—the lack of security—does not outweigh all of the other factors in favor of debt.

Accordingly, the trial evidence, when reviewed as a whole, conclusively shows that the Rowes' advances to Indmar were bona fide loans. The Tax Court committed clear error in finding otherwise.

III.CONCLUSION

For the foregoing reasons, we reverse the Tax Court's determination that the stockholders' advances were equity contributions. We find that the advances exhibited clear, objective indicia of bona fide debt. Accordingly, we also reverse the Tax Court's assessment of accuracy-related penalties.

■ Rogers, Circuit Judge, concurring.

I concur fully in the majority opinion. I write separately to explain why the legal, non-factual components of the tax court's analysis are properly examined on appeal without deference to the tax court, notwithstanding the overall "clearly erroneous" standard that our court has stated to be applicable to the determination of whether a particular transaction is debt or equity. [Judge Rogers went on to discuss the conflicting precedents on the standard of review and concluded that, when the underlying facts are not in dispute, an appellate court should not apply the clearly erroneous standard to the debt vs. equity issue, which is a mixed question of fact and law. Ed.] Applying "clearly erroneous" deference to lower court legal determinations, no matter how hidden or embedded such determinations are in overall determinations that are partly or even largely factual, is fundamentally at odds with the rule of law.[1]

■ Moore, Circuit Judge, dissenting.

[Judge Moore's dissent, which supported application of the clearly erroneous standard of review, has been omitted. Ed.]

2. Hybrid Instruments

The types of financial instruments available to investors have proliferated. As one commentator has described the reality of today's world of corporate finance, "[i]n exchange for capital, corporations can offer investors any set of rights that can be described by words, subject to any conceivable set of qualifications, and in consideration of any conceivable set of offsetting obligations."[64]

The flexibility afforded corporate issuers has contributed to an array of exotic products that seek "best of both worlds" treatment—i.e., debt for tax purposes and equity for regulatory, financial rating, and accounting purposes. These hybrid instruments have been created and marketed by large financial institutions and Wall Street law firms who have advised corporate issuers that they may deduct the "interest" paid on the purported debt while treating the instruments as equity for financial statement or regulatory purposes. The excerpt below, from a study by the Joint Committee on Taxation on the tax treatment of business debt, surveys some of the incentives to create hybrid instruments.

Joint Committee on Taxation, Present Law and Background Relating to the Tax Treatment of Business Debt *

July 11, 2011 (JCX–41–11), 80–85.

Incentives to create hybrid instruments

In general

Taxpayers have significant flexibility to create economically similar instruments and categorize them as debt or equity. In general, instruments are not bifurcated into part debt and part equity, and the categorization as one type of instrument or the other applies across the board for all tax purposes. Taxpayers may have incentives to create instruments with hybrid features, that is, having features of both debt and equity, either solely for Federal income tax purposes, or because of additional benefits that may occur if the instrument is classified in a different manner for other purposes such as financial reporting, regulatory capital, or foreign tax purposes.

For example, issuers may seek to structure an instrument offering many of the attributes of equity while still providing an interest deduction. Some investors may seek debt-like protections while allowing for the possibility of sharing in the earnings or appreciation of a business. [If] instruments characterized as debt for tax purposes contain significant equity like features, the economic risks of high leverage might be mitigated. For example, a debt instrument having a long term that permits deferral of cash interest or principal payments, or an instrument that allows final payment of interest or principal (or both) in an amount of issuer stock rather than cash, may provide some cushion against an issuer's default and bankruptcy. Similarly, debt instruments held by a shareholder of the issuer could be perceived by third parties as equity-like to the extent the debt-holding stockholders are less likely to exercise their rights as creditors and drive a troubled issuer into bankruptcy. Such shareholders might instead voluntarily cancel or restructure their debt to avoid bankruptcy and preserve the potential for the corporation to improve its performance and ultimately increase their overall return through their return to equity.

To the extent debt provides interest deductions but also some flexibility against causing bankruptcy and lacks covenants that inhibit operations, it might be viewed in the marketplace as creating a less risky capital structure than other, more restrictive debt.

* * *

Corporate interest deductions on certain hybrid instruments

A corporation may issue debt that is convertible to corporate equity. Such an instrument could be viewed as part debt and part equity, with the amount paid to the corporation being attributable in part to the fixed interest debt instrument, and in part to the conversion feature. Treasury regulations and rulings provide inconsistent results for similar types of instruments, depending upon how the conversion feature is structured. If an instrument is simply convertible into stock of the issuer or related party, the amount of the interest deduction that is considered the economic equivalent of a payment on the amount attributable to conversion features is denied.

Under an IRS ruling,[1] if the instrument is not automatically convertible at a specific price, but rather is convertible only if one or more contingencies is satisfied (e.g., only if corporate earnings or share prices change by a specified threshold amount), then the rules for determining the market comparable for interest deduction purposes allow the instrument to be treated as if it did not have a conversion feature, thus allowing more interest to be deducted in advance of actual payment. Depending on the point at which the fixed conversion price is set compared to the conditions of the contingency, the two instruments could be economically very similar. The IRS has solicited comments on whether the approach allowing deductible interest to be determined as if there were no contingency should be extended beyond contingent convertible bonds. Commentators have expressed different views and have noted other inconsistencies in the treatment of potentially similar instruments that offer a debt holder the opportunity to participate in corporate growth or appreciation. The inconsistencies in treatment may allow taxpayers to select the treatment most favorable by proper structuring of the investment.

A corporation also may issue debt that is under certain circumstances payable in corporate equity. Section 163(*l*) denies interest deductions for such instruments. The IRS has ruled that certain hybrid instruments are not within the scope of this denial.[2]

Advantages when debt instruments for tax is treated as equity or part equity for financial accounting, rating agency or regulatory purposes

Federal income tax is not the only context in which classification of an instrument as debt or equity has significance. And because classification rules applicable in different contexts vary, taxpayers have designed hybrid instruments to achieve different, advantageous results under the different rules. Examples of other contexts include rules under U.S. GAAP determining the treatment of instruments for financial accounting purposes, bank regulatory rules determining whether an instrument qualifies as equity capital for purposes of bank capital requirements and the rules of various rating agencies considering how an instrument is treated for purposes of financial tests in assigning credit ratings to issuers. Although the treatment of an instrument for non-tax purposes is a factor in the Federal income tax classification analysis, it is not determinative.

Trust preferred securities[3] are an example of a hybrid securities instrument developed, and adapted over time, to be classified differently for tax, financial

accounting, regulatory or rating agency purposes. Trust preferred securities are an instrument used to raise capital involving the creation of an additional entity to stand between the corporation raising the funds and the investors in the instrument.[4] For example, a corporation interested in raising capital could issue debt or preferred stock directly to investors. As an alternative, in the case of trust preferred securities, a corporate issuer forms a passthrough entity by contributing capital in exchange for a common equity interest. The passthrough entity then sells preferred equity interests to investors. The passthrough entity then lends the money it received from the corporation (as a capital contribution) and the investors (in exchange for the preferred equity interests) back to the corporation. As a result, the corporation has funds raised from investors, and has an obligation to make payments on indebtedness to the newly created passthrough entity. Payments on the corporation—passthrough entity indebtedness are typically designed to match the payments required on the passthrough entity-investor preferred securities. In other words, the passthrough entity operates as a conduit to receive payments of interest from the corporation, which it pays on to its preferred interest holders.

Prior to changes in the financial accounting rules in 2003, the simplified structure described above allowed the corporation interest deductions on amounts paid through to the investors for Federal tax purposes without treating the arrangement as a liability for financial accounting purposes. For Federal income tax purposes, the debt between the corporate issuer and the passthrough entity was designed to qualify as debt. Similarly, the terms of the preferred interests issued to investors was designed to qualify as debt for Federal income tax purposes even if treated as issued by the corporate issuer directly. Under U.S. GAAP rules, the passthrough entity was consolidated with the corporate issuer, with the effect that the loan between the corporate issuer and the passthrough entity (which would be treated as a liability for GAAP) was ignored for financial accounting purposes, and the preferred securities were treated as issued directly by the corporation. These preferred securities were designed to qualify as equity for GAAP purposes.

In 2003, U.S. GAAP rules were revised to require that trust preferred securities be reflected as a liability for financial accounting purposes. However, the trust preferred security structure has also involved benefits for credit rating purposes. Very generally, rating agencies such as Moody's Investor services and Standard and Poor's may assign a credit rating to certain company instruments. These agencies are concerned primarily with a company's ability to make payments on an instrument as required, without default. An important component of such an analysis is the composition of the issuer's capital structure, and the degree of flexibility a company has in periods of impaired cash flow. For example, Moody's Investor Services' rules have granted partial "equity credit" to hybrid instruments that allow, like trust preferred securities, for the deferral of periodic payments. In effect, giving "equity credit" for hybrid instruments could make such instruments more attractive to issuers than other financing alternatives, especially if such credit improved the company's credit rating.

In addition to credit rating benefits, for an issuer of trust preferred securities that is a bank holding company, such securities were designed to count as Tier 1 regulatory capital. Very generally, under U.S. bank regulatory capital requirements, banks are required to hold some minimum level of capital (e.g., three percent of total assets) and satisfy a minimum risk-based capital ratio (e.g., a ratio of total capital to total risk-weighted assets of eight percent). These requirements are generally designed to insure banks hold capital sufficient to absorb potential losses. Debt issued directly by a bank could give rise to tax deductible interest payments, but would not qualify as capital for regulatory purposes. Preferred stock issued directly by the bank could count as equity capital, but generally would not give rise to interest deductions. For certain banks, specifically, bank holding companies regulated by the Federal Reserve Board, trust preferred securities meeting certain requirements counted as Tier 1 capital. For banks other than bank holding companies, trust preferred securities did not count as Tier 1 capital. Section 171(b) of the Dodd-Frank Wall Street Reform and Protection Act generally phases out the treatment of trust preferred securities as Tier 1 capital for most large bank and thrift holding companies.

* * *

3. Section 385

Code: § 385.

Background. Many years ago, Congress concluded that a determined effort was needed to alleviate the uncertainties flowing from the debt/equity case law, especially in light of "the increasing use of debt for corporate acquisition purposes."[65] Frustrated in its attempt to draft precise definitions, Congress delegated the chore to the executive branch by enacting Section 385, which authorizes the Treasury to promulgate such regulations "as may be necessary or appropriate" to determine for all tax purposes whether an interest in a corporation is to be treated as stock or debt. Section 385(b) requires the regulations to set forth "factors" to be taken into account in determining whether a debtor-creditor relationship exists and specifies the following factors which may (but need not) be included in the regulations:

(1)Form—i.e., whether the instrument is evidenced by a written, unconditional promise to pay a sum certain on demand or on a specific date in return for an adequate consideration and bears a fixed interest rate.

(2)Subordination to any indebtedness of the corporation.

(3)The debt/equity ratio.

(4)Convertibility into stock.

(5)Proportionality—i.e., the relationship between holdings of stock in the corporation and holdings of the purported debt interest being scrutinized.

The Regulations Project. Section 385 was hailed by leading commentators as "perhaps the most important and potentially far-reaching corporate provision added

by the Tax Reform Act of 1969,"[66] and the literature was replete with predictions as to the content of the regulations.[67] In March, 1980, 11 years after Section 385 was enacted, the Treasury issued a lengthy, detailed and controversial set of proposed regulations.[68] "Final" regulations were promulgated in December, 1980,[69] followed by amendments and effective date extensions, but all versions of the regulations were withdrawn in 1983[70] and the project has since been abandoned.

Although a detailed examination of the now long defunct regulations would not be productive, some features are noteworthy if only because they represented a concentrated attempt to bring order out of the chaos. For example, the regulations[71] distinguished straight debt from hybrid instruments, appropriately relegating hybrid securities to second class status. A "hybrid" was defined as an instrument convertible into stock or providing for any contingent payment to the holder.[72] In virtually all cases, hybrids would have been treated as preferred stock for tax purposes, at least if they were not held by independent creditors.[73] Straight debt—defined as anything other than a hybrid instrument[74]—still had a fighting chance of avoiding reclassification if certain other requirements were met.

The concept of proportionality played a central role in the regulatory scheme because "it generally makes little economic difference (aside from tax consequences) whether proportionate shareholder advances are made as debt or equity * * * ."[75]Elaborate definitions of proportionality were provided, and special scrutiny was required for instruments held in substantial proportion to equity investments.[76]

Another contribution of the regulations was their precise definition of two debt/equity ratios—"outside" (which took into account *all* liabilities, including those to independent creditors) and "inside" (considering only shareholder debt).[77] Corollary rules provided that assets were to be reflected at adjusted basis rather than fair market value and trade liabilities were to be disregarded.[78]The debt/equity ratio was used to determine whether a corporation's debt was "excessive". A debt was excessive if the instrument's terms and conditions, viewed in combination with the corporation's financial structure, would not have been satisfactory to a bank or other financial institution making ordinary commercial loans.[79] It was not excessive, however, if the outside debt/equity ratio did not exceed 10-to-1 and the inside debt/equity ratio did not exceed 3-to-1.[80] Thus, even proportionate straight debt issued for cash would not be reclassified if it fell within this safe harbor from "excessive debt" and bore a "reasonable" (within specified ranges) interest rate. Variations on these themes abounded.

The regulations were withdrawn because lobbyists convinced the Treasury that they would have a negative impact on particular industries and on small businesses generally.[81] Although some of the regulatory themes ultimately may be adopted by the courts, the Treasury is unlikely to initiate the mobilization that would be required to resurrect this project.

Bifurcation of Instruments. Despite the Treasury's lack of success in implementing the goals of Section 385, Congress has not given up hope. Section 385 was amended to allow (but not require) the Treasury to classify an interest having

significant debt and equity characteristics as "in part stock and in part indebtedness."[82] According to the legislative history, bifurcation may be appropriate where a debt instrument provides for payments that are dependent to a significant extent on corporate performance, such as through "equity kickers" (i.e., provisions in a debt instrument that provide the holder with an equity interest in certain circumstances), contingent interest (which is dependent on corporate performance), significant deferral of payment, subordination, or an interest rate high enough to suggest a significant risk of default.[83]

If the Treasury ever accepts this Congressional challenge, several options could be considered. One approach would disallow interest deductions in excess of a specified rate of return to investors on the theory that a higher than normal risk is tantamount to an equity investment. For example, the regulations might specify a reference rate (such as the rate on comparable-term Treasury obligations) that is relatively risk-free and permit interest paid up to that rate to be deductible but deny a deduction for the additional "risk" element because it is more akin to a dividend. Under this type of broad disallowance approach, a corporation that issued a 20-year $100,000 unsecured debt instrument paying 14 percent interest (14,000 per year) at a time when comparable Treasury bonds were yielding 10 percent would be permitted to deduct only $10,000 per year as interest and the remaining $4,000 per year would be a nondeductible dividend.[84]

Another option is to limit bifurcation to instruments that provide for a combination of a fixed return and an additional return based on earnings. The regulations might treat the fixed return as interest while classifying the performance-based component as a nondeductible dividend. A closely related alternative, which finds isolated support in the case law, would be to divide one instrument into separate components—i.e., one part as debt and another as equity.[85]

Obligation of Consistency. Section 385(c) provides that a corporate issuer's characterization of an instrument as debt or equity at the time of issuance shall be binding on the issuer and all holders of the interest—but not binding, of course, on the Service. This rule of consistency does not apply, however, to holders who disclose on their tax return that they are treating the interest in a manner inconsistent with the issuer's characterization.

Recent Section 385 Regulatory Efforts. In April 2016, the Service issued proposed regulations under Section 385 that primarily affected the treatment of indebtedness between related parties for tax purposes.[86] The proposed regulations were intended to curb what the Service believed to be certain abusive transactions used by multinational corporations to shift income outside the United States, but they potentially had a broader reach. Highlights included: (1) strict documentation and other procedural requirements that must be met as a prerequisite for treating certain related-party transactions as debt; (2) a new per se rule that automatically reclassifies certain related-party transactions as equity without regard to the multi-factor tests under current law; and (3) authorization for the Service to treat certain

related-party interests as part debt and part equity based on the "substance" of the instrument.

After receiving a barrage of critical comments, the Service issued much narrower final and temporary regulations in October 2016.[87] One notable change that is easily understood was the removal of IRS authorization to bifurcate instruments into part debt and part equity.

The final and temporary regulations were met with congressional criticism, and in 2017 the IRS delayed application of the strict documentation regulations.[88] Later in 2017, the Treasury Department, as part of its effort to identify and reduce tax regulatory burdens, included the documentation regulations as a candidate for revocation and replacement by a substantially streamlined and simplified version with a delayed effective date to allow time for comments and compliance.[89]

The Future. Perhaps in the 22nd century, when comprehensive Section 385 regulations are reissued, we will have regulatory guidance on classification of debt and equity.

Problems

1. Aristocrat, Baker and Chef have formed Chez Guevara, Inc. ("Chez") as a C corporation to operate a gourmet restaurant and bakery previously operated by Chef as a sole proprietorship. Aristocrat will contribute $80,000 cash, Baker will contribute a building with a fair market value of $80,000 and an adjusted basis of $20,000, and Chef will contribute $40,000 cash and the goodwill from his proprietorship with an agreed value of $40,000 and has a zero basis. In return, each of the parties will receive 100 shares of Chez common stock, the only class outstanding.

Chez requires at least $1,800,000 of additional capital in order to renovate the building, acquire new equipment and provide working capital. It has negotiated a $900,000 loan from Friendly National Bank on the following terms: interest will be payable at two points above the prime rate, determined semi-annually, with principal due in ten years and the loan will be secured by a mortgage on the renovated restaurant building.

Evaluate the following alternative proposals for raising the additional $900,000 needed to commence business, focusing on the possibility that the Service will reclassify corporate debt instruments as equity:

(a) Aristocrat, Baker and Chef each will loan Chez $300,000, and each will take back a $300,000 five-year corporate note with variable interest payable at one point below the prime rate, determined annually.

(b) Same as (a), above except that each of the parties will take back $300,000 of 10% 20-year subordinated income debentures; interest will be payable only out of the net profits of the business.

(c) Same as (a), above, except that the $900,000 loan from Friendly National Bank will be unsecured but personally guaranteed by Aristocrat, Baker and Chef, who will be jointly and severally liable.

(d) Aristocrat will loan the entire $900,000, taking back a $900,000 corporate note with terms identical to those described in (a), above.

(e) Same as (d), above, except that commencing two years after the incorporation, Chez ceases to pay interest on the notes because of a severe cash flow problem.

2. In view of the confused state of the law, how should a tax advisor plan the capital structure of a corporation to avoid the risk of reclassification of debt as equity. From the standpoint of the tax advisor, is the vagueness of the law in this area preferable to more detailed "bright line" rules in the Code or regulations? Which approach is preferable as a matter of policy?

C. Character of Gain or Loss on Corporate Investment

Code: §§ 165(g)(1), (2); 166(a), (d), (e); 1244(a)–(c). Skim §§ 1045; 1202.

Regulations: §§ 1.165–5(a)–(c); 1.166–5; 1.1244(a)–1(a), (b).

Since equity and debt securities held by investors are usually capital assets, gain or loss on the sale of stock, bonds and other debt instruments generally is a capital gain or loss.[90] As discussed below, the Code also includes a few special characterization rules, some to stimulate investment and others to clarify the tax treatment of transactions that technically do not constitute a "sale or exchange."

Gain on Sale of Qualified Small Business Stock. To encourage long-term investment in smaller start-up companies, Section 1202 generally permits noncorporate shareholders who are original issuees of stock in a domestic C corporation to exclude from gross income 100 percent of the gain from a sale or exchange of "qualified small business stock" acquired after September 27, 2010 and held for more than five years.[91] The exclusion is available to a shareholder for up to $10 million of recognized gain per qualifying corporation.[92] To qualify its stock for this tax benefit, the issuer generally must: (1) never have had gross assets in excess of $50 million (including the proceeds of the newly issued stock) before and immediately after the stock is issued[93]; (2) meet certain active trade or business requirements;[94] and (3) not violate various other special limitations, including restrictions on purchases by the corporation of its own stock.[95] Another valuable tax benefit is provided by Section 1045, which allows noncorporate shareholders to elect to defer otherwise taxable gain from a sale of qualified small business stock held for more than six months by rolling over the proceeds into new qualified small business stock within 60 days of the sale.

Worthless Securities. Even the most optimistic taxpayers who embark on a business venture are well advised to anticipate the tax consequences if their endeavor should result in a loss. Sole proprietors, partners (including members of limited liability companies) and shareholders in an S corporation may deduct the losses from

their business operations as they are incurred if they materially participate in the activity.[96] But shareholders or creditors of a C corporation normally must be content to recognize a capital loss at the time their investment is sold or becomes worthless. If a loss results from the worthlessness of stock or debt evidenced by a "security" which is a capital asset, the calamity is treated as a hypothetical sale or exchange on the last day of the taxable year in which the loss is incurred.[97]

Debts Not Evidenced by a Security. For noncorporate lenders, the tax consequences of losses sustained on a debt not evidenced by a security are governed by the bad debt deduction rules in Section 166. Business bad debts are ordinary losses, while nonbusiness bad debts are artificially treated as short-term capital losses.[98] When a shareholder who is also an employee loans money to a closely held corporation and later is not repaid, an issue arises over whether the loan was made as an investment or in a trade or business carried on by the taxpayer. The loss almost always is treated as a nonbusiness bad debt on the theory that the dominant motivation for making the loan was to protect the taxpayer's investment in the corporation rather than his employment relationship.[99]

Section 1244 Stock. As discussed above, it is virtually impossible for shareholders to avoid nonbusiness bad debt treatment if they sustain a loss in their creditor capacity. Whatever their roles, corporate insiders generally are regarded as investors.[100] These rules place corporate investors who suffer losses at a tax disadvantage relative to those who conduct their affairs through other business vehicles. In the case of a small business, this dichotomy makes little sense and may prove to be particularly unfair to those who are forced into the C corporation form for nontax reasons. In the same legislation that produced the earliest version of Subchapter S, Congress provided some limited relief by enacting Section 1244 in order to "encourage the flow of new funds into small business" by placing small business shareholders on more of a par with proprietors and partners.[101] If certain detailed statutory requirements are met, an individual shareholder may (within limits) treat a loss from the sale, exchange or worthlessness of "Section 1244 stock" as an ordinary loss even if it might otherwise have been treated as a capital loss.

Because Section 1244 was designed to stimulate investment in small businesses, only individual taxpayers and partnerships (but not trusts and estates) who were original issuees of the stock are eligible for ordinary loss treatment.[102] Donees, heirs and other transferees of the original investor will continue to be limited to capital loss treatment under Section 165.

Section 1244 stock may be either common or preferred stock that has been issued for money or property.[103] Stock issued for services thus does not qualify.[104] To prevent the benefits of Section 1244 from extending beyond the small business community, its reach is limited to stock of a "small business corporation," a status achieved if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital and as paid-in surplus does not exceed $1,000,000.[105] This determination is made at the time the stock is issued, but the $1,000,000 cap includes

both amounts received for the newly issued stock and any stock previously issued by the corporation.[106]

Qualification under Section 1244 when the stock is issued does not automatically guarantee that an ordinary loss will be allowed when a loss is realized. Section 1244(c)(1)(C) also requires that, for the five taxable years ending before the year in which the loss was sustained, the corporation must have derived more than 50 percent of its aggregate gross receipts from sources other than passive investment income items (royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities). The requirement is designed to preclude ordinary loss treatment to shareholders of corporations engaged primarily in investment rather than active business activities. If these investment losses had been incurred directly, the taxpayer would have been limited to capital loss treatment and the corporate form should not facilitate an end run around this limitation. If the loss is sustained before the corporation has a five-year measuring period, then the gross receipts test is applied by substituting the taxable years ending before the date of the loss in which the corporation was in existence.[107]

The aggregate amount that may be treated by the taxpayer as an ordinary loss for any one taxable year may not exceed $50,000 or, in the case of married couple filing a joint return, $100,000.[108] In the case of partnerships, the limit is determined separately as to each partner.[109]

Section 1244 is a "no lose" provision in the sense that nothing is lost by passing a corporate resolution declaring that an equity interest is being issued as Section 1244 stock even if the stock ultimately fails to qualify. Although there is no longer a requirement for a formal plan, it generally is regarded as good practice to include a reference to Section 1244 in the corporate resolution approving the issuance of stock in a qualifying corporation, if only to remind the shareholders that ordinary loss treatment is available if that unhappy event should later occur.

Problem

High Technologies, Inc. ("Hi-Tech") is a small semiconductor company owned and operated by Thelma High and Allen Woody. Thelma and Allen formed Hi-Tech as a C corporation three years ago by each contributing $400,000 in exchange for 50 percent of the corporation's common stock. Hi-Tech has been planning a major expansion of its manufacturing facility and has decided to seek outside financing. It recently approached Jennifer Leech about the possibility of her investing $200,000 in Hi-Tech.

After investigating the corporation's financial position, Jennifer has decided to make the investment. Her objectives are to obtain maximum security while at the same time participating in Hi-Tech's potential growth. Jennifer also is concerned about the rapid change in computer technology and would like to plan for the most favorable tax consequences in the unfortunate event that her investment in Hi-Tech becomes worthless. Consider to what extent Jennifer will realize her economic and tax goals if, in the alternative, her investment takes the following forms:

(a) A $200,000 unregistered five-year Hi-Tech note bearing market rate interest.

(b) A $200,000 Hi-Tech registered bond bearing market rate interest.

(c) A $190,000 Hi-Tech registered bond bearing market rate interest and $10,000 for warrants to purchase Hi-Tech common stock at a favorable price.

(d) $200,000 of Hi-Tech common stock.

(e) $200,000 of Hi-Tech convertible preferred stock.

(f) Same as (d), above, except Thelma and Allen originally capitalized Hi-Tech by each contributing $500,000.

(g) Same as (d), above, except Jennifer plans to give the Hi-Tech common stock to her son, Peter, as a wedding gift.

(h) Same as (d), above, except Jennifer and her son, Peter, will purchase the Hi-Tech common stock through Leech Associates, a venture capital partnership.

Endnotes

[1] Commissioner v. O.P.P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935).

[2] For a general discussion of the debate, Klein, Coffee & Partnoy, Business Organization and Finance, Legal and Economic Principles 352–385 (11th ed. 2010).

[3] The statement in the text is belied by the surge of debt financing that accompanied the corporate mergers and restructurings of the 1980s, the significant increases in corporate debt beginning in 2001, and the continuing increase in corporate debt financing. See Soni, "How Concerning are Corporate Debt Levels?," March 7, 2019 at https://seekingalpha.com/article/4247445-concerning-corporate-debt-levels (reporting that U.S. corporations have about $9 trillion of debt, which is approximately 46 percent of GDP, a record level).

[4] The dividends received deduction provides some additional tax relief for corporate shareholders. See I.R.C. § 243 and Chapter 4A, infra.

[5] I.R.C. § 163(a).

[6] But see Andrews, "Tax Neutrality Between Equity Capital and Debt," 30 Wayne L. Rev. 1057 (1984), suggesting that this traditional "simple view" is inadequate because it fails to recognize the opportunity for corporations to raise equity capital by accumulating earnings—a process that redounds to the benefit of shareholders without subjecting them to tax until the earnings are distributed or the shares are sold.

[7] I.R.C. § 302. See Chapter 5C, infra.

[8] I.R.C. §§ 531 et seq. See Chapter 14B, supra.

[9] Reg. § 1.537–2(b)(3). Repayment of debt owed to shareholders, however, may be subjected to greater scrutiny. See Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197 (4th Cir.1957), cert. denied 354 U.S. 922, 77 S.Ct. 1383 (1957).

[10]See, e.g., Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 7.07.

[11]A 2016 study by researchers at the Tax Policy Center concluded that only about 25 percent of all U.S. corporate stock is held by taxable investors, down from nearly 84 percent in 1965. The other 75 percent is held in tax-exempt accounts, such as IRAs and other retirement funds, or by foreigners or nonprofit organizations. See Rosenthal & Austin, "The Dwindling Taxable Share of U.S. Corporate Stock," 151 Tax Notes 923 (May 16, 2016).

[12]See Chapter 2F2, infra.

[13]See Section C of this chapter, infra.

[14]See Section A2 of this chapter, infra.

[15]See Hackbarth & Zhou, Effects of New Tax Law on Capital Structure and Cost of Capital, 158 Tax Notes 1523 (March 2018), which summarizes research on the effects of the Tax Reform Act of 1986, which reduced the corporate tax rate from 46 percent to 36 percent, and tax law changes over longer periods, including the last century.

[16]Id.

[17]H. Rep. No. 115–409, 115th Cong., 1st Sess. 247 (2017) (footnote omitted).

[18]I.R.C. § 163(j)(1).

[19]I.R.C. § 163(j)(2).

[20]See I.R.C. § 163(j)(4).

[21]I.R.C. § 163(j)(5), (6).

[22]I.R.C. § 163(j)(8).

[23]I.R.C. § 163(j)(3).

[24]I.R.C. § 163(j)(7)(A)(ii), (B).

[25]I.R.C. § 163(j)(7)(A)(iii), (C). Regulated public utilities also are exempted. I.R.C. § 163(j)(7)(A)(iv).

[26]REG–106089 (Nov. 26, 2018), 2019–05 I.R.B. 431.

[27]Prop. Reg. § 1.163(j)–4(c)(1).

[28]Betancourt, Nichols & Scott, "Tax Reform's Interest Deduction Limitation: Preliminary Evidence," 160 Tax Notes 1545 (Sept. 10, 2018). The sample also uses GAAP EBIT and EBITDA as proxies for ATI, which is acknowledged as limitation.

[29]Id.

[30]Id. Some have also pursued strategies which employ offshore borrowing.

[31]See I.R.C. § 279(a)–(c).

[32]I.R.C. § 279(d)(5), (e) & (f). See also, I.R.C. § 279(g) regarding the rules when the issuing corporation is a member of an affiliated group.

[33]A zero coupon bond is a debt instrument that pays no interest and is sold at a significant discount from its face value.

[34]See I.R.C. §§ 1272–1273.

[35]See I.R.C. § 163(e)(5), (i).

[36]A virtually incomprehensible definition of "significant original issue discount" appears in Section 163(i)(2). Oversimplifying considerably, OID is "significant" if the OID income that accrues in periods ending more than five years after the bond is issued exceeds interest actually paid on the bond.

[37]"Payments" for this purpose are limited to actual payments of cash or property other than the stock or debt of the issuer. I.R.C. § 163(i)(3)(B).

[38]I.R.C. § 163(e)(5)(A), (B).

[39]I.R.C. § 163(e)(5)(C).

[40]I.R.C. § 163(*l*)(2). The definition also includes several specialized arrangements with a similar effect.

[41]Reg. § 1.6043–4(c)(1)(iii) & (d)(1).

[42]The characterization of an instrument at its issuance is binding on the issuer, but not the Service. I.R.C. § 385(c)(1). A holder of an instrument generally is bound by the issuer's characterization unless the holder discloses an inconsistent position on a tax return. I.R.C. § 385(c)(2).

[43]Commissioner v. Union Mutual Insurance Co. of Providence, 386 F.2d 974, 978 (1st Cir.1967).

[44]Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 4.04 (4th ed. 1979).

[45]For this reason, the Service ordinarily declines to issue advance rulings on the classification on an instrument as debt or equity. Rev. Proc. 2016–3, § 4.02(1), 2016–1 I.R.B. 137. The courts are divided over whether the debt vs. equity question is one of fact or law, or a mixed question of fact and law. See Indmar Products Co., Inc. v. Commissioner, infra p. 128.

[46]See generally Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 Tax L. Rev. 369 (1971), a classic article that somehow manages to survey the landscape with only 1,591 footnotes. For a less ancient summary, see Hariton, "Essay: Distinguishing Between Equity and Debt in the New Financial Environment," 49 Tax L. Rev. 499 (1994).

[47]See Wood Preserving Corp. v. United States, 347 F.2d 117, 119 (4th Cir.1965).

[48]See Fellinger v. United States, 363 F.2d 826 (6th Cir.1966).

[49]See Schnitzer v. Commissioner, 13 T.C. 43 (1949).

[50]See Bradshaw v. United States, 231 Ct.Cl. 144, 683 F.2d 365, 367–68 (1982) (50-to-1 ratio not fatal because corporation was likely to and did in fact pay off debts when due); Baker Commodities, Inc. v. Commissioner, 48 T.C. 374 (1967), affirmed, 415 F.2d 519 (9th Cir.1969), cert. denied, 397 U.S. 988, 90 S.Ct. 1117 (1970) (692-to-1 ratio is acceptable because cash flow and earning power of business could cover payments).

[51]Compare Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir.1967) (improved real estate; debt traditionally high) with John Lizak, Inc. v. Commissioner, 28 T.C.M. 804 (1969)(construction business less able to carry heavy debt burden).

[52]See Gooding Amusement Co. v. Commissioner, 23 T.C. 408, 419 (1954), affirmed, 236 F.2d 159 (6th Cir.1956), cert. denied, 352 U.S. 1031, 77 S.Ct. 595 (1957).

[53]See, e.g., Delta Plastics, Inc. v. Commissioner, 85 T.C.M. 940 (2003) (26-to-1 ratio was acceptable because likely success of business would reduce ratio to 4-to-1 within three years).

[54]Compare Ambassador Apartments, Inc. v. Commissioner, 50 T.C. 236, 245 (1968), affirmed, 406 F.2d 288 (2d Cir.1969) (consider outside debt) with P.M. Finance Corp. v. Commissioner, 302 F.2d 786, 788 (3d Cir.1962) (consider only shareholder debt).

[55]Compare Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir.1967) (disregard shareholder guaranteed debt) with Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir.1972), cert. denied, 409 U.S. 1076, 93 S.Ct. 683 (1972) (shareholder guaranteed debt recharacterized as equity contribution by guarantor.)

[56]See Nye v. Commissioner, 50 T.C. 203, 216 (1968). In Bauer v. Commissioner, 748 F.2d 1365 (9th Cir.1984), the court computed stockholders' equity by adding together paid-in capital and retained earnings and arrived at outside debt/equity ratios for different years ranging from approximately 2 to 1 to 8 to 1. The Tax Court had determined a ratio for one year of approximately 92 to 1 by limiting shareholders' equity to initial paid-in capital.

[57]See Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir.1956), cert. denied, 352 U.S. 1031, 77 S.Ct. 595 (1957).

[58]Indmar Products Co., Inc. v. Commissioner, infra p. 128; Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir.1968); Gilbert v. Commissioner, 248 F.2d 399 (2d Cir.1957).

[59]See Slappey Drive Industrial Park v. United States, 561 F.2d 572, 582 (5th Cir.1977); Estate of Mixon v. United States, 464 F.2d 394, 409 (5th Cir.1972).

[60]See Charter Wire, Inc. v. United States, 309 F.2d 878, 880 (7th Cir.1962), cert. denied, 372 U.S. 965, 83 S.Ct. 1090 (1963).

[61]For a negative view, see Harlan v. United States, 409 F.2d 904, 909 (5th Cir.1969) (proportionality may be considered but has no significant importance).

[62]See P.M. Finance Corp. v. Commissioner, 302 F.2d 786, 789–90 (3d Cir.1962); R.C. Owen Co. v. Commissioner, 23 T.C.M. 673, 676 (1964), affirmed, 351 F.2d 410 (6th Cir.1965), cert. denied, 382 U.S. 967, 86 S.Ct. 1272 (1966).

[63]See Tyler v. Tomlinson, 414 F.2d 844 (5th Cir.1969).

Indmar Products Footnotes

[2]The government took pains during trial to show that Indmar could have received a lower interest rate from FTB than its stockholders. Had the 10% rate been exorbitant, this would have been a useful line of inquiry. Under the circumstances here, the rate was not exorbitant, and whether Indmar could have received a better

rate through FTB is of no import. To show bona fide debt, a taxpayer does not need to prove that it received the financially optimal rate, just a commercially reasonable one.

[5]As the Tax Court did not address this factor, it made no credibility determinations with respect to Richard Rowe's testimony relating to the use of the advancements. At one point in its decision the Tax Court did find that Rowe's testimony was "contradictory, inconsistent, and unconvincing" and that the parties "manipulated facts," but this was in specific reference to its discussion about the inconsistent treatment of the advances as demand debt and long-term debt.

[1]Indeed, commentators have expressed concern that there is no predictable legal distinction between loans to a business and equity investment, and that the unpredictability of this legal distinction is partially caused by the issue being "treated as one of fact to be resolved by applying vague standards. . . ." See Stephen A. Lind, Stephen Schwarz, Daniel J. Lathrope & Joshua D. Rosenberg, Fundamentals of Business Enterprise Taxation 474 (3d ed.2005). These authors note, "Exhaustive research leaves one with the firm conviction that the courts are applying an amorphous and highly unsatisfactory 'smell test.' " Id.

Endnotes (contd.)

[64]Hariton, "Distinguishing Between Equity and Debt in the New Financial Environment," 49 Tax L. Rev. 499, 501 (1994).

JCT Extract Footnotes

[*]Some footnotes have been omitted, and others have been renumbered.

[1]Rev. Rul. 2002–31.

[2]See, e.g., Rev. Rul. 2003–97, 2003–34 I.R.B. 380.

[3]The term "trust preferred securities" as used in this pamphlet is a generic term for various, but similar, financial products including monthly income preference shares (MIPS), trust originated preferred securities (TOPrS), quarterly income preference shares (QUIPS), trust preferred securities (TruPS), and more recent variants such as enhanced capital advantaged preferred securities (ECAPS) and Enhanced TruPS (ETruPS).

[4]The additional entity can be a foreign limited liability company, a domestic partnership or state law trust. Different structures have used different entities for a variety of non-tax reasons over time including compliance with securities laws, transaction costs and investor convenience.

Endnotes (contd.)

[65]S.Rep. No. 91–552, 91st Cong., 1st Sess. 511 (1969), reprinted in 1969–3 C.B. 423, 511. See also H.R.Rep. No. 91–413, 91st Cong., 1st Sess. 265 (1969), reprinted in 1969–3 C.B. 200, 265.

[66]Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 4.05 (3rd ed. 1971).

[67]Id. at 4–16 to 4–19. See also Recommendations as to Federal Tax Distinction between Corporate Stock and Indebtedness, N.Y. State Bar Association Tax Section Committee on Reorganization Problems, 25 Tax Law. 57 (1971).

[68]45 Fed.Reg. 18957 (1980).

[69]T.D. 7747 (filed Dec. 29, 1980), 45 Fed.Reg. 86438 (Dec. 31, 1980), known as the "December 29" regulations.

[70]T.D. 7920, 48 Fed.Reg. 31054 (July 6, 1983).

[71]Unless otherwise indicated, citations which follow are to the December 30, 1981 version of the regulations.

[72]Prop. Reg. § 1.385–3(d).

[73]Prop. Reg. § 1.385–0(c)(2).

[74]Prop. Reg. § 1.385–3(e).

[75]T.D. 7747, 45 Fed.Reg. 86438, 86440 (Explanation of Changes), reprinted in 1981–1 C.B. 143.

[76]Prop. Reg. § 1.385–6. In general, proportional straight debt instruments were treated as debt only if issued to "independent creditors" or if they were marketable instruments issued by a public company; otherwise they generally were reclassified as equity unless they were: (a) issued for cash or, if issued for property, the stated annual interest rate was "reasonable," and (b) the corporation did not have "excessive debt" at the time the instrument was issued. Prop. Reg. § 1.385–6(a)(3), (e), (g).

[77]Prop. Reg. § 1.385–6(g)(4).

[78]Prop. Reg. § 1.385–6(h).

[79]Prop. Reg. § 1.385–6(f)(2).

[80]Prop. Reg. § 1.385–6(g)(3).

[81]See, e.g., Levin & Bowen, "The Section 385 Regulations Regarding Debt Versus Equity: Is the Cure Worse than the Malady?" 35 Tax Law. 1 (1981).

[82]I.R.C. § 385(a). This regulatory authority may be exercised on a prospective basis only.

[83]H.Rep. No. 101–247, 101st Cong., 1st Sess. 1236 (1989).

[84]In narrowly targeted situations, Congress began moving in this direction with the legislation enacted in 1989. See, e.g., I.R.C. §§ 163(e)(5), (i). Query whether any broader approach would discriminate against start-up companies or firms engaged in high-risk businesses?

[85]Two courts have used this approach with respect to hybrid instruments. See Richmond, Fredericksburg and Potomac R.R. v. Commissioner, 528 F.2d 917 (4th Cir.1975); Farley Realty Corp. v. Commissioner, 279 F.2d 701 (2d Cir.1960). In most other cases, the courts have applied an all-or-nothing approach.

[86]REG–108060–15, 2016–17 I.R.B. 636.

[87]T.D. 9790, 2016–45 I.R.B. 540.

[88]Notice 2017–36, 2017–33 I.R.B. 208.

[89]REG–130244–17, 2018–41 I.R.B. 591.

[90]In some cases, where the original issue discount and market discount rules apply, all or part of the gain on the sale or maturity of a debt instrument may be ordinary income. See generally I.R.C. §§ 1271–1275.

[91]I.R.C. § 1202(a)(1), (4). For qualified stock acquired on or before September 27, 2010, a smaller percentage (50 or 75 percent) may be excluded, 7 percent of the excluded amount is an alternative minimum tax preference item, and the taxable portion of "Section 1202 gain" is taxed at a maximum rate of 28 percent rather than the generally applicable long-term capital gains rate. I.R.C. §§ 1202(a)(3); 1(h)(4), (7). Certain specialized types of C corporations, such as mutual funds and REITS, and corporations engaging in certain types of businesses (e.g., providing professional services, banking, farming, natural resources, and hotels) do not qualify for the exclusion. I.R.C. § 1202(e)(3), (4).

[92]I.R.C. § 1202(b)(1)(A). In some situations involving larger investors, higher limits may apply. I.R.C. § 1202(b)(1)(B).

[93]I.R.C. § 1202(d).

[94]I.R.C. § 1202(e).

[95]I.R.C. § 1202(c)(3).

[96]See generally I.R.C. § 469 for limitations on the timing of losses incurred in a passive activity.

[97]See I.R.C. §§ 165(g)(1), (2).

[98]I.R.C. § 166(a), (d).

[99]United States v. Generes, 405 U.S. 93, 92 S.Ct. 827 (1972).

[100]See, e.g., Benak v. Commissioner, 77 T.C. 1213 (1981); but see Bowers v. Commissioner, 716 F.2d 1047 (4th Cir.1983).

[101]H.R.Rep. No. 2198, 85th Cong., 1st Sess. (1958), reprinted in 1959–2 C.B. 709, 711.

[102]I.R.C. § 1244(a). A partner qualifies for a Section 1244 ordinary loss only if he was a partner when the partnership acquired the stock. Reg. § 1.1244(a)–1(b)(2). The regulations also provide that ordinary loss treatment is not available to a partner who has received the stock in a distribution from the partnership. Reg. § 1.1244(a)–1(b). Unlike a partnership, an S corporation is not eligible for ordinary loss treatment under Section 1244. Rath v. Commissioner, 101 T.C. 196 (1993).

[103]I.R.C. § 1244(c)(1)(B).

[104]Reg. § 1.1244(c)–1(d).

[105]I.R.C. § 1244(c)(3).

[106]Id. See also Reg. § 1.1244(c)–2(b). If the capital receipts exceed $1,000,000, the corporation may designate certain shares as Section 1244 stock provided that the amounts received for such designated stock do not exceed $1,000,000 less amounts received for stock or as capital contributions in prior years.

[107]I.R.C. § 1244(c)(2)(A).

[108]I.R.C. § 1244(b).
[109]Reg. § 1.1244(b)–1(a).

Ajay Gupta
Financial Products Taxation
Reading #2

Taxation of Stock Dividends Under Section 305

Code: §§ 301(a)-(d); 305(a)-(d); 307; 312(d)(1)(B), (f)(2); 1223(4).

Regulations: §§ 1.305-1, -2, -3(a), (b), (c), (e) Examples (1)-(4), (8), (10) & (11), -4, -5(a), -6, -7(a); 1.307-1.

Eisner v. Macomber, 252 U.S. 189 (1920).

Treatise: Keyes, Federal Taxation of Financial Instruments & Transactions, Chapter 1, Stock Distributions Under Section 305, ¶¶ 1.01-1.05 (Optional).

Problem:

Hill Corporation is organized with two classes of voting common stock: Class A and Class B. Shares in each class of stock have an equal right to Hill's assets and earnings and profits. Frank owns 100 shares of Class A stock, and Fay and Joyce each own 50 shares of Class B stock.

Assuming that Hill Corporation has ample earnings and profits, determine whether the following distributions are taxable under § 301 or excludable under § 305(a):

(a) A pro rata distribution of nonconvertible preferred stock to both classes of shareholders.

(b) A pro rata distribution of Class A stock on Class A and Class B on Class B. The Class B shareholders also are given the option to take cash in lieu of additional Class B shares. Joyce exercises this option.

(c) A pro rata distribution of Class A stock on Class A and a cash distribution on Class B.

(d) Assume that Class B is a class of nonconvertible preferred stock which pays regular cash dividends and Hill distributes Class B stock to the Class A shareholder.

(e) Same as (d), above, except that Hill distributes a class of nonconvertible preferred stock which has rights to assets and earnings and profits subordinate to those of the existing Class B stock (i.e., "junior" nonconvertible preferred stock) to the Class A shareholder.

(f) Assume that Hill has only one class of common stock outstanding and also has issued a series of 10 percent debentures convertible into common stock at the rate of one share of common stock for each $1,000 debenture. Hill makes an annual interest payment to the debenture holders and one month later distributes a "common on common" stock dividend to the common shareholders without adjusting the conversion ratio on the debentures.

(g) Same as (f), above, except that the debentures are convertible preferred stock. The corporation declares a one-for-one split on the common stock (i.e., each shareholder receives one new share of common stock for each old share) and the conversion ratio of the preferred is doubled.

(h) Assume again that Class A and Class B are both classes of voting common stock. Hill makes a pro rata distribution of Class A on Class A and a distribution of newly issued shares of nonconvertible preferred stock on Class B.

(i) Same as (h), above, except that the preferred stock which is distributed is convertible into Class B stock over 20 years at Class B's market price on the day of the distribution.

ing the grounds for the refusal by the Commission to receive the proof or report concerning it, challenged the right to the relief sought. A demurrer to the answer as stating no defense was overruled by the trial court, which denied relief without opinion. In the Court of Appeals, two judges sitting, the judgment of the trial court was affirmed by a divided court, also without opinion, and the case is here on writ of error to review that judgment.

It is obvious from the statement we have made, as well as from the character of the remedy invoked, mandamus, that we are required to decide, not a controversy growing out of duty performed under the statute, but one solely involving an alleged refusal to discharge duties which the statute exacts. Admonishing, as this does, that the issue before us is confined to a consideration of the face of the statute and the nonaction of the Commission in a matter purely ministerial, it serves also to furnish a ready solution of the question to be decided, since it brings out in bold contrast the direct and express command of the statute to the Commission to act concerning the subject in hand, and the Commission's unequivocal refusal to obey such command.

[1] It is true that the Commission held that its nonaction was caused by the fact that the command of the statute involved a consideration by it of matters "beyond the possibility of rational determination," and called for "inadmissible assumptions," and the indulging in "impossible hypotheses" as to subjects "incapable of rational ascertainment," and that such conclusions were the necessary consequence of the Minnesota Rate Cases, 230 U. S. 352, 33 Sup. Ct. 729, 57 L. Ed. 1511, 48 L. R. A. (N. S.) 1151, Ann. Cas. 1916A, 18.

We are of opinion, however, that, considering the face of the statute and the reasoning of the Commission, it results that the conclusion of the Commission was erroneous, an error which was exclusively caused by a mistak-

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en *conception by the Commission of its relation to the subject, resulting in an unconscious disregard on its part of the power of Congress and an unwitting assumption by the Commission of authority which it did not possess. And the significance which the Commission attributed to the ruling in the Minnesota Rate Cases, even upon the assumption that its view of the ruling in those cases was not a mistaken one, but illustrates in a different form the disregard of the power of Congress which we have just pointed out, since, as Congress indisputably had the authority to impose upon the Commission the duty in question, it is impossible to conceive how the Minnesota Rate ruling could furnish ground for refusing to carry out the commands of Congress, the cogency of which consideration is none the less manifest, though it be borne in mind that the Minnesota Rate Cases were decided after the passage of the act in question.

[2] Finally, even if it be further conceded that the subject-matter of the valuations in question which the act of Congress expressly directed to be made necessarily opened a wide range of proof and called for the exercise of close scrutiny and of scrupulous analysis in its consideration and application, such assumption, we are of opinion, affords no basis for refusing to enforce the act of Congress, or what is equivalent thereto, of exerting the general power which the act of Congress gave, and at the same time disregarding the essential conditions imposed by Congress upon its exercise.

The judgment of the Court of Appeals is therefore reversed, with directions to reverse that of the Supreme Court, and direct the Supreme Court to grant a writ of mandamus in conformity with this opinion.

(252 U. S. 189)

EISNER, Internal Revenue Collector, v. MACOMBER.

(Argued April 16, 1919. Restored to Docket for Reargument, May 19, 1919. Reargued Oct. 17 and 20, 1919. Decided March 8, 1920.)

No. 318.

1. COURTS ⟸92 — REASONING FURNISHING BASIS FOR CONCLUSION NOT OBITER.

Reasoning of the court, which furnishes the entire basis for the conclusion reached, cannot be regarded as obiter dictum.

2. CONSTITUTIONAL LAW ⟸18—AMENDMENT TO BE CONSTRUED IN CONNECTION WITH ORIGINAL CONSTITUTION.

The Income Tax Amendment (Const. Amend. 16) must be construed in connection with the taxing clauses of the original Constitution, and the effect attributed to them before the amendment was adopted.

3. INTERNAL REVENUE ⟸7—EFFECT OF INCOME TAX AMENDMENT STATED.

Const. Amend. 16, did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income.

4. INTERNAL REVENUE ⟸4 — INCOME TAX AMENDMENT NOT TO BE EXTENDED BY CONSTRUCTION.

Const. Amend. 16, should not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal.

5. INTERNAL REVENUE ⟸7—STATUTORY DEFINITION OF INCOME NOT CONCLUSIVE.

The question of what constitutes income, within Const. Amend. 16, cannot be concluded by any definition which Congress may adopt.

⟸For other cases see same topic and KEY-NUMBER in all Key-Numbered Digests and Indexes

6. INTERNAL REVENUE ⟸7—"INCOME" DEFINED.

"Income" is the gain derived from capital, from labor, or from both combined; something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, and received or drawn by the recipient for his separate use, benefit, and disposal.

[Ed. Note.—For other definitions, see Words and Phrases, First and Second Series, Income.]

7. CORPORATIONS ⟸65—NATURE OF STOCKHOLDER'S INTEREST.

The interest of a stockholder is a capital interest, and his certificates of stock are but evidence of it.

8. CORPORATIONS ⟸65—STOCKHOLDER CANNOT WITHDRAW ANY PART OF CORPORATE PROPERTY.

Short of liquidation, or until dividend declared, a stockholder may not withdraw any part of either capital or profits from the enterprise; his interest not pertaining to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company.

9. CORPORATIONS ⟸65—TITLE TO PROPERTY IS IN CORPORATION, NOT IN STOCKHOLDERS.

The interest of a stockholder in the property, etc., of the company is not that of an owner, since the corporation has full legal and equitable title to the whole.

10. INTERNAL REVENUE ⟸7 — STOCK DIVIDEND NOT "INCOME."

A stock dividend, consisting of new stock issued to the stockholders in proportion to their previous holdings, for profits capitalized, without any distribution of profits, is not "income," within Const. Amend. 16, and Revenue Act, Sept. 8, 1916, § 2 (Comp. St. § 6336b), in so far as it provides for the taxation thereof as income, without apportionment of the tax according to population, violates Const. art. 1, § 2, cl. 3, and section 9, cl. 4.

11. INTERNAL REVENUE ⟸7—PROFIT ON SALE OF STOCK RECEIVED AS DIVIDEND IS "INCOME."

If a stockholder receiving a stock dividend sells the stock so received any profit on the sale is income, and, so far as it may have arisen since the Sixteenth Amendment, is taxable by Congress without apportionment according to population.

12. INTERNAL REVENUE ⟸7 — CORPORATION MUST BE TREATED AS ENTITY IN DETERMINING WHAT CONSTITUTES INCOME.

In determining whether stock dividends constitute income, taxable under Const. Amend. 16, the corporation must be treated as a separate entity, as it is only by recognizing such separateness that any dividend can be regarded as income of the stockholder.

13. INTERNAL REVENUE ⟸7 — ENRICHMENT THROUGH INCREASE IN VALUE OF CAPITAL INVESTMENT NOT "INCOME."

Enrichment through increase in value of capital investment is not income, within Const. Amend. 16.

14. INTERNAL REVENUE ⟸2—TAX ON INTEREST OF STOCKHOLDER IN UNDIVIDED PROFITS MUST BE APPORTIONED.

Revenue Act Sept. 8, 1916, § 2 (Comp. St. § 6336b), providing that stock dividends shall be considered income, if construed as imposing the tax on the stockholder's interest in the accumulated and undivided profits, rather than on the dividend, is invalid, as taxing property because of ownership, without apportionment according to population.

Mr. Justice Brandeis, Mr. Justice Clarke, Mr. Justice Holmes, and Mr. Justice Day, dissenting.

In Error to the District Court of the United States for the Southern District of New York.

Action by Myrtle H. Macomber against Mark Eisner, as Collector of Internal Revenue for the Third District of the State of New York. Judgment for plaintiff on demurrer, and defendant brings error. Affirmed.

Mr. Assistant Attorney General Frierson, for plaintiff in error.

Messrs. Charles E. Hughes and George Welwood Murray, both of New York City, for defendant in error.

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*Mr. Justice PITNEY delivered the opinion of the Court.

This case presents the question whether, by virtue of the Sixteenth Amendment, Congress has the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by the corporation since March 1, 1913.

It arises under the Revenue Act of September 8, 1916 (39 Stat. 756 et seq., c. 463 [Comp. St. § 6336a et seq.]), which, in our opinion (notwithstanding a contention of the govern-

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ment that will be *noticed), plainly evinces the purpose of Congress to tax stock dividends as income.[1]

The facts, in outline, are as follows:

On January 1, 1916, the Standard Oil Company of California, a corporation of that state, out of an authorized capital stock of

[1] Title I.—Income Tax.

Part I.—On Individuals.

Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived, * * * also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: Provided, that the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, * * * which stock dividend shall be considered income, to the amount of its cash value.

$100,000,000, had shares of stock outstanding, par value $100 each, amounting in round figures to $50,000,000. In addition, it had surplus and undivided profits invested in plant, property, and business and required for the purposes of the corporation, amounting to about $45,000,000, of which about $20,000,000 had been earned prior to March 1, 1913, the balance thereafter. In January, 1916, in order to readjust the capitalization, the board of directors decided to issue additional shares sufficient to constitute a stock dividend of 50 per cent. of the outstanding stock, and to transfer from surplus account to capital stock account an amount equivalent to such issue. Appropriate resolutions were adopted, an amount equivalent to the par value of the proposed new stock was transferred accordingly, and the new stock duly issued against it and divided among the stockholders.

Defendant in error, being the owner of 2,200 shares of the old stock, received cer-

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tificates for 1,100 additional *shares, of which 18.07 per cent., or 198.77 shares, par value $19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916. She was called upon to pay, and did pay under protest, a tax imposed under the Revenue Act of 1916, based upon a supposed income of $19,877 because of the new shares; and an appeal to the Commissioner of Internal Revenue having been disallowed, she brought action against the Collector to recover the tax. In her complaint she alleged the above facts, and contended that in imposing such a tax the Revenue Act of 1916 violated article 1, § 2, cl. 3, and article 1, § 9, cl. 4, of the Constitution of the United States, requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the Sixteenth Amendment. A general demurrer to the complaint was overruled upon the authority of Towne v. Eisner, 245 U. S. 418, 38 Sup. Ct. 158, 62 L. Ed. 372, L. R. A. 1918D, 254; and, defendant having failed to plead further, final judgment went against him. To review it, the present writ of error is prosecuted.

The case was argued at the last term, and reargued at the present term, both orally and by additional briefs.

We are constrained to hold that the judgment of the District Court must be affirmed: First, because the question at issue is controlled by Towne v. Eisner, supra; secondly, because a re-examination of the question with the additional light thrown upon it by elaborate arguments, has confirmed the view that the underlying ground of that decision is sound, that it disposes of the question here presented, and that other fundamental considerations lead to the same result.

In Towne v. Eisner, the question was whether a stock dividend made in 1914 against surplus earned prior to January 1, 1913, was taxable against the stockholder under the Act of October 3, 1913 (38 Stat. 114, 166, c. 16), which provided (section B, p. 167) that net income should include "dividends,"

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and also "gains or profits and income de*rived from any source whatever." Suit having been brought by a stockholder to recover the tax assessed against him by reason of the dividend, the District Court sustained a demurrer to the complaint. 242 Fed. 702. The court treated the construction of the act as inseparable from the interpretation of the Sixteenth Amendment; and, having referred to Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 15 Sup. Ct. 912, 39 L. Ed. 1108, and quoted the Amendment, proceeded very properly to say (242 Fed. 704):

"It is manifest that the stock dividend in question cannot be reached by the Income Tax Act and could not, even though Congress expressly declared it to be taxable as income, unless it is in fact income."

It declined, however, to accede to the contention that in Gibbons v. Mahon, 136 U. S. 549, 10 Sup. Ct. 1057, 34 L. Ed. 525, "stock dividends" had received a definition sufficiently clear to be controlling, treated the language of this court in that case as obiter dictum in respect of the matter then before it (242 Fed. 706), and examined the question as res nova, with the result stated. When the case came here, after overruling a motion to dismiss made by the government upon the ground that the only question involved was the construction of the statute and not its constitutionality, we dealt upon the merits with the question of construction only, but disposed of it upon consideration of the essential nature of a stock dividend disregarding the fact that the one in question was based upon surplus earnings that accrued before the Sixteenth Amendment took effect. Not only so, but we rejected the reasoning of the District Court, saying (245 U. S. 426, 38 Sup. Ct. 159, 62 L. Ed. 372, L. R. A. 1918D, 254):

"Notwithstanding the thoughtful discussion that the case received below we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former. 'A stock dividend really takes nothing from the property of the corporation, and adds noth-

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ing to the *interests of the shareholders. Its property is not diminished, and their interests are not increased. * * * The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' Gibbons v. Mahon, 136 U. S. 549, 559, 560 [10 Sup. Ct. 1057, 34 L. Ed. 525]. In short, the corporation is no poorer and the stockholder

is no richer than they were before. Logan County v. United States, 169 U. S. 255, 261 [18 Sup. Ct. 361, 42 L. Ed. 737]. If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450. the sum upon which he was taxed. * * * What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new."

This language aptly answered not only the reasoning of the District Court but the argument of the Solicitor General in this court, which discussed the essential nature of a stock dividend. And if, for the reasons thus expressed, such a dividend is not to be regarded as "income" or "dividends" within the meaning of the act of 1913, we are unable to see how it can be brought within the meaning of "incomes" in the Sixteenth Amendment; it being very clear that Congress intended in that act to exert its power to the extent permitted by the amendment. In Towne v. Eisner it was not contended that any construction of the statute could make it narrower than the constitutional grant; rather the contrary.

The fact that the dividend was charged against profits earned before the act of 1913 took effect, even before the amendment was adopted, was neither relied upon nor alluded to in our consideration of the merits in that case. Not only so, but had we considered that a stock dividend constituted income in any true sense, it would have been held taxable under the act of 1913 notwithstanding it was *based upon profits earned before the amendment. We ruled at the same term, in Lynch v. Hornby, 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149, that a cash dividend extraordinary in amount, and in Peabody v. Eisner, 247 U. S. 347, 38 Sup. Ct. 546, 62 L. Ed. 1152, that a dividend paid in stock of another company, were taxable as income although based upon earnings that accrued before adoption of the amendment. In the former case, concerning "corporate profits that accumulated before the act took effect," we declared (247 U. S. 343, 344, 38 Sup. Ct. 543, 545 [62 L. Ed. 1149]):

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"Just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, his interest in them comes to fruition as income, that is, in dividends declared, so we can perceive no constitutional obstacle that stands in the way of carrying out this intent when dividends are declared out of a pre-existing surplus. * * * Congress was at liberty under the amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing."

In Peabody v. Eisner, 247 U. S. 349, 350, 38 Sup. Ct. 546, 547 (62 L. Ed. 1152), we observed that the decision of the District Court in Towne v. Eisner had been reversed "only upon the ground that it related to a stock dividend which in fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the evidence which represented that interest," and we distinguished the Peabody Case from the Towne Case upon the ground that "the dividend of Baltimore & Ohio shares was not a stock dividend but a distribution in specie of a portion of the assets of the Union Pacific."

[1] Therefore Towne v. Eisner cannot be regarded as turning upon the point that the surplus accrued to the company before the act took effect and before adoption of the amendment. And what we have quoted from the opinion in that case cannot be regarded as obiter dictum, it having furnished the entire basis for the conclusion reached. We adhere to the view then expressed, and might rest the present case there, not because that case in terms decided the constitutional question, for it did not, but because the conclusion there reached as to the essential nature of a stock dividend necessarily prevents its being regarded as income in any true sense.

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Nevertheless, in view of the importance of the matter, and the fact that Congress in the Revenue Act of 1916 declared (39 Stat. 757 [Comp. St. § 6336b]) that a "stock dividend shall be considered income, to the amount of its cash value," we will deal at length with the constitutional question, incidentally testing the soundness of our previous conclusion.

[2] The Sixteenth Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the amendment was adopted. In Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 15 Sup. Ct. 912, 39 L. Ed. 1108, under the Act of August 27, 1894 (28 Stat. 509, 553, c. 349, § 27), it was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were in effect direct taxes upon the property from which such income arose, imposed by reason of ownership; and that Congress could not impose such taxes without apportioning them among the states according to population, as required by article 1, § 2, cl. 3, and section 9, cl. 4, of the original Constitution.

[3] Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the Sixteenth Amendment was adopted, in words lucidly expressing the object to be accomplished:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source

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derived, without apportionment among *the several states, and without regard to any census or enumeration."

As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income. Brushaber v. Union Pacific R. R. Co., 240 U. S. 1, 17–19, 36 Sup. Ct. 236, 60 L. Ed. 493, Ann. Cas. 1917B, 713, L. R. A. 1917D, 414; Stanton v. Baltic Mining Co., 240 U. S. 103, 112 et seq., 36 Sup. Ct. 278, 60 L. Ed. 546; Peck & Co. v. Lowe, 247 U. S. 165, 172, 173, 38 Sup. Ct. 432, 62 L. Ed. 1049.

[4] A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

[5] In order, therefore, that the clauses cited from article 1 of the Constitution may have proper force and effect, save only as modified by the amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not "income," as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.

The fundamental relation of "capital" to "income" has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term

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"in*come," as used in common speech, in order to determine its meaning in the amendment, and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.

[6] After examining dictionaries in common use (Bouv. L. D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (Stratton's Independence v. Howbert, 231 U. S. 399, 415, 34 Sup. Ct. 136, 140 [58 L. Ed. 285]; Doyle v. Mitchell Bros. Co., 247 U. S. 179, 185, 38 Sup. Ct. 467, 469 [62 L. Ed. 1054]), "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case, 247 U. S. 183, 185, 38 Sup. Ct. 467, 469 (62 L. Ed. 1054).

Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain," which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. *"Derived—from—capital"*; "the *gain—derived—from—capital*," etc. Here we have the essential matter: *not* a gain *accruing to* capital; not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *"derived"*—that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal—*that* is income derived from property. Nothing else answers the description.

The same fundamental conception is clearly set forth in the Sixteenth Amendment—"incomes, *from* whatever *source derived*"—

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the essential thought being expressed *with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

Can a stock dividend, considering its essential character, be brought within the definition? To answer this, regard must be had to the nature of a corporation and the stockholder's relation to it. We refer, of course, to a corporation such as the one in the case at bar, organized for profit, and having a capital stock divided into shares to which a nominal or par value is attributed.

[7-9] Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the corporate existence to attainment of the common objects, entitled to vote at stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate share of the net assets, if any, remaining after paying creditors. Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or

profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned; but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return.

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If he desires to dissociate himself *from the company he can do so only by disposing of his stock.

[10] For bookkeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a "capital stock account." If profits have been made and not divided they create additional bookkeeping liabilities under the head of "profit and loss," "undivided profits," "surplus account," or the like. None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose. The dividend normally is payable in money, under exceptional circumstances in some other divisible property; and when so paid, then only (excluding, of course, a possible advantageous sale of his stock or winding-up of the company) does the stockholder realize a profit or gain which becomes his separate property, and thus derive income from the capital that he or his predecessor has invested.

In the present case, the corporation had surplus and undivided profits invested in

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plant, property, and business, and required for the purposes of the corporation, amounting to about $45,000,000, in addition to outstanding capital stock of $50,000,000. In this the case is not extraordinary. The profits of a corporation, as they appear upon the balance sheet at the end of the year, need not be in the form of money on hand in excess of what is required to meet current liabilities and finance current operations of the company. Often, especially in a growing business, only a part, sometimes a small part, of the year's profits is in property capable of division; the remainder having been absorbed in the acquisition of increased plant, *equipment, stock in trade, or accounts receivable, or in decrease of outstanding liabilities. When only a part is available for dividends, the balance of the year's profits is carried to the credit of undivided profits, or surplus, or some other account having like significance. If thereafter the company finds itself in funds beyond current needs it may declare dividends out of such surplus or undivided profits; otherwise it may go on for years conducting a successful business, but requiring more and more working capital because of the extension of its operations, and therefore unable to declare dividends approximating the amount of its profits. Thus the surplus may increase until it equals or even exceeds the par value of the outstanding capital stock. This may be adjusted upon the books in the mode adopted in the case at bar—by declaring a "stock dividend." This, however, is no more than a book adjustment, in essence not a dividend but rather the opposite; no part of the assets of the company is separated from the common fund, nothing distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution. In order to make the adjustment, a charge is made against surplus account with corresponding credit to capital stock account, equal to the proposed "dividend"; the new stock is issued against this and the certificates delivered to the existing stockholders in proportion to their previous holdings. This, however, is merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the form, not the essence, of the "liability" acknowledged by the corporation to its own shareholders, and this through a readjustment of accounts on one side of the balance sheet only, increasing

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"capital stock" at the expense of *"surplus"; it does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.

A "stock dividend" shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar

of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment.

Being concerned only with the true character and effect of such a dividend when lawfully made, we lay aside the question whether in a particular case a stock dividend may be authorized by the local law governing the corporation, or whether the capitalization of profits may be the result of correct judgment and proper business policy on the part of its management, and a due regard for the interests of the stockholders. And we are considering the taxability of bona fide stock dividends only.

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*We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.

[11] It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company likewise is diminished. Thus, if one holding $60,000 out of a total $100,000 of the capital stock of a corporation should receive in common with other stockholders a 50 per cent. stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority stockholder, having six-fifteenths instead of six-tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock; it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock, and a like diminution of the seller's comparative voting power—that "right preservative of rights" in the control

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of a corporation. *Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.

Throughout the argument of the government, in a variety of forms, runs the fundamental error already mentioned—a failure to appraise correctly the force of the term "income" as used in the Sixteenth Amendment, or at least to give practical effect to it. Thus the government contends that the tax "is levied on income derived from corporate earnings," when in truth the stockholder has "derived" nothing except paper certificates which, so far as they have any effect, deny him present participation in such earnings. It contends that the tax may be laid when earnings "are received by the stockholder," whereas he has received none; that the profits are "distributed by means of a stock dividend," although a stock dividend distributes no profits; that under the act of 1916 "the tax is on the stockholder's share in corporate earnings," when in truth a stockholder has no such share, and receives none in a stock dividend; that "the profits are segregated from his former capital, and he has a separate certificate representing his invested profits or gains," whereas there has been no segregation of profits, nor has he any separate certificate representing a personal gain, since the certificates, new and old, are alike in what they represent—a capital interest in the entire concerns of the corporation.

[12] We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But,

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looking through the form, *we cannot disregard the essential truth disclosed, ignore the substantial difference between corporation and stockholder, treat the entire organization as unreal, look upon stockholders as partners, when they are not such, treat them as having in equity a right to a partition of the corporate assets, when they have none, and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it;

and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.

[13] Conceding that the mere issue of a stock dividend makes the recipient no richer than before, the government nevertheless contends that the new certificates measure the extent to which the gains accumulated by the corporation have made him the richer. There are two insuperable difficulties with this: In the first place, it would depend upon how long he had held the stock whether the stock dividend indicated the extent to which he had been enriched by the operations of the company; unless he had held it throughout such operations the measure would not hold true. Secondly, and more important for present purposes, enrichment through increase in

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value *of capital investment is not income in any proper meaning of the term.

The complaint contains averments respecting the market prices of stock such as plaintiff held, based upon sales before and after the stock dividend, tending to show that the receipt of the additional shares did not substantially change the market value of her entire holdings. This tends to show that in this instance market quotations reflected intrinsic values—a thing they do not always do. But we regard the market prices of the securities as an unsafe criterion in an inquiry such as the present, when the question must be, not what will the thing sell for, but what is it in truth and in essence.

It is said there is no difference in principle between a simple stock dividend and a case where stockholders use money received as cash dividends to purchase additional stock contemporaneously issued by the corporation. But an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend, such as the one we have under consideration, where nothing of value is taken from the company's assets and transferred to the individual ownership of the several stockholders and thereby subjected to their disposal.

The government's reliance upon the supposed analogy between a dividend of the corporation's own shares and one made by distributing shares owned by it in the stock of another company, calls for no comment beyond the statement that the latter distributes assets of the company among the shareholders while the former does not, and for no citation of authority except Peabody v. Eisner, 247 U. S. 347, 349, 350, 38 Sup. Ct. 546, 62 L. Ed. 1152.

Two recent decisions, proceeding from courts of high jurisdiction, are cited in support of the position of the government.

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*Swan Brewery Co., Ltd. v. Rex, [1914] A. C. 231, arose under the Dividend Duties Act of Western Australia, which provided that "dividend" should include "every dividend, profit, advantage, or gain intended to be paid or credited to or distributed among any members or directors of any company," except, etc. There was a stock dividend, the new shares being allotted among the shareholders pro rata; and the question was whether this was a distribution of a dividend within the meaning of the act. The Judicial Committee of the Privy Council sustained the dividend duty upon the ground that, although "in ordinary language the new shares would not be called a dividend, nor would the allotment of them be a distribution of a dividend," yet, within the meaning of the act, such new shares were an "advantage" to the recipients. There being no constitutional restriction upon the action of the lawmaking body, the case presented merely a question of statutory construction, and manifestly the decision is not a precedent for the guidance of this court when acting under a duty to test an act of Congress by the limitations of a written Constitution having superior force.

In Tax Commissioner v. Putnam (1917) 227 Mass. 522, 116 N. E. 904, L. R. A. 1917F, 806, it was held that the Forty-Fourth amendment to the Constitution of Massachusetts, which conferred upon the Legislature full power to tax incomes, "must be interpreted as including every item which by any reasonable understanding can fairly be regarded as income" (227 Mass. 526, 531, 116 N. E. 904, 907 [L. R. A. 1917F, 806]), and that under it a stock dividend was taxable as income; the court saying (227 Mass. 535, 116 N. E. 911, L. R. A. 1917F, 806):

"In essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which instead of being paid out in cash is invested in the business, thus augmenting its durable assets. In this aspect of the case the substance of the transaction is no different from what it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares."

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*We cannot accept this reasoning. Evidently, in order to give a sufficiently broad sweep to the new taxing provision, it was deemed necessary to take the symbol for the substance, accumulation for distribution, capital accretion for its opposite; while a case where money is paid into the hand of the stockholder with an option to buy new shares with it, followed by acceptance of the option, was regarded as identical in substance with a case where the stockholder receives no money and has no option. The Massachusetts court was not under an obligation, like

the one which binds us, of applying a constitutional amendment in the light of other constitutional provisions that stand in the way of extending it by construction.

[14] Upon the second argument, the government, recognizing the force of the decision in Towne v. Eisner, supra, and virtually abandoning the contention that a stock dividend increases the interest of the stockholder or otherwise enriches him, insisted as an alternative that by the true construction of the act of 1916 the tax is imposed, not upon the stock dividend, but rather upon the stockholder's share of the undivided profits previously accumulated by the corporation; the tax being levied as a matter of convenience at the time such profits become manifest through the stock dividend. If so construed, would the act be constitutional?

That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question, and that such interests might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this court.

The government relies upon Collector v. *218 Hubbard (1870) *12 Wall. 1, (20 L. Ed. 272), which arose under section 117 of the act of June 30, 1864 (13 Stat. 223, 282, c. 173), providing that—

"The gains and profits of all companies, whether incorporated or partnership, other than the companies specified in that section, shall be included in estimating the annual gains, profits, or income of any person, entitled to the same, whether divided or otherwise."

The court held an individual taxable upon his proportion of the earnings of a corporation although not declared as dividends and although invested in assets not in their nature divisible. Conceding that the stockholder for certain purposes had no title prior to dividend declared, the court nevertheless said (12 Wall. 18, 20 L. Ed. 272):

"Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees."

In so far as this seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared, it must be regarded as overruled by Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 627, 628, 637, 15 Sup. Ct. 912, 39 L. Ed. 1108. Conceding Collector v. Hubbard was inconsistent with the doctrine of that case, because it sustained a direct tax upon property not ap- *219 portioned *among the states, the government nevertheless insists that the Sixteenth Amendment removed this obstacle, so that now the Hubbard Case is authority for the power of Congress to levy a tax on the stockholder's share in the accumulated profits of the corporation even before division by the declaration of a dividend of any kind. Manifestly this argument must be rejected, since the amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income. As we have pointed out, a stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation, prior to dividend declared.

Thus, from every point of view we are brought irresistibly to the conclusion that neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder. The Revenue Act of 1916, in so far as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of article 1, § 2, cl. 3, and article 1, § 9, cl. 4, of the Constitution, and to this extent is invalid, notwithstanding the Sixteenth Amendment.

Judgment affirmed.

Mr. Justice HOLMES, dissenting.

I think that Towne v. Eisner, 245 U. S. 418, 38 Sup. Ct. 158, 62 L. Ed. 372, L. R. A. 1918D, 254, was right in its reasoning and result and that on sound principles the stock dividend was not income. But it was clearly intimated in that case that the construction of the statute then before the Court might be different from that of the Constitution. 245 U. S. 425, 38 Sup. Ct. 158, 62 L. Ed. 372, L. R. A. 1918D, 254. I think that the word "incomes" in the Sixteenth Amendment should be read *220 in *"a sense most obvious to the common understanding at the time of its adoption." Bishop v. State, 149 Ind. 223, 230, 48 N. E. 1038, 1040, 39 L. R. A. 278, 63 Am. St. Rep. 270; State v. Butler, 70 Fla. 102, 133, 69 South. 771. For it was for public adoption that it was proposed. McCulloch v. Maryland, 4 Wheat. 316, 407, 4 L. Ed. 579. The

known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. I am of opinion that the Amendment justifies the tax. See Tax Commissioner v. Putnam, 227 Mass. 522, 532, 533, 116 N. E. 904, L. R. A. 1917F, 806.

Mr. Justice DAY concurs in this opinion.

Mr. Justice BRANDEIS delivered the following [dissenting] opinion:

Financiers, with the aid of lawyers, devised long ago two different methods by which a corporation can, without increasing its indebtedness, keep for corporate purposes accumulated profits, and yet, in effect, distribute these profits among its stockholders. One method is a simple one. The capital stock is increased; the new stock is paid up with the accumulated profits; and the new shares of paid-up stock are then distributed among the stockholders pro rata as a dividend. If the stockholder prefers ready money to increasing his holding of the stock in the company, he sells the new stock received as a dividend. The other method is slightly more complicated. Arrangements are made for an increase of stock to be offered to stockholders pro rata at par, and, at the same time, for the payment of a cash dividend equal to the amount which the stock-

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holder will be required to pay to *the company, if he avails himself of the right to subscribe for his pro rata of the new stock. If the stockholder takes the new stock, as is expected, he may endorse the dividend check received to the corporation and thus pay for the new stock. In order to ensure that all the new stock so offered will be taken, the price at which it is offered is fixed far below what it is believed will be its market value. If the stockholder prefers ready money to an increase of his holdings of stock, he may sell his right to take new stock pro rata, which is evidenced by an assignable instrument. In that event the purchaser of the rights repays to the corporation, as the subscription price of the new stock, an amount equal to that which it had paid as a cash dividend to the stockholder.

Both of these methods of retaining accumulated profits while in effect distributing them as a dividend had been in common use in the United States for many years prior to the adoption of the Sixteenth Amendment. They were recognized equivalents. Whether a particular corporation employed one or the other method was determined sometimes by requirements of the law under which the corporation was organized; sometimes it was determined by preferences of the individual officials of the corporation; and sometimes by stock market conditions. Whichever method was employed the resultant distribution of the new stock was commonly referred to as a stock dividend. How these two methods have been employed may be illustrated by the action in this respect (as reported in Moody's Manual, 1918 Industrial, and the Commercial and Financial Chronicle) of some of the Standard Oil companies, since the disintegration pursuant to the decision of this court in 1911. Standard Oil Co. v. United States, 221 U. S. 1, 31 Sup. Ct. 502, 55 L. Ed. 619, 34 L. R. A. (N. S.) 834, Ann. Cas. 1912D, 734.

(a) Standard Oil Co. (of Indiana), an Indiana corporation. It had on December 31, 1911, $1,000,000 capital stock (all common),

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and a large surplus. On May 15, *1912, it increased its capital stock to $30,000,000, and paid a simple stock dividend of 2,900 per cent. in stock. [2]

(b) Standard Oil Co. (of Nebraska), a Nebraska corporation. It had on December 31, 1911, $600,000 capital stock (all common), and a substantial surplus. On April 15, 1912, it paid a simple stock dividend of 33⅓ per cent., increasing the outstanding capital to $800,000. During the calendar year 1912 it paid cash dividends aggregating 20 per cent., but it earned considerably more, and had at the close of the year again a substantial surplus. On June 20, 1913, it declared a further stock dividend of 25 per cent., thus increasing the capital to $1,000,000. [3]

(c) The Standard Oil Co. (of Kentucky), a Kentucky corporation. It had on December 31, 1913, $1,000,000 capital stock (all common) and $3,701,710 surplus. Of this surplus $902,457 had been earned during the calendar year 1913, the net profits of that year having been $1,002,457 and the dividends paid only $100,000 (10 per cent.). On December 22, 1913, a cash dividend of $200 per share was declared payable on February 14, 1914, to stockholders of record January 31, 1914, and these stockholders were offered the right to subscribe for an equal amount of new stock at par and to apply the cash dividend in payment therefor. The outstanding stock was thus increased to $3,000,000. During the calendar years 1914, 1915, and 1916, quarterly dividends were paid on this stock at an annual rate of between 15 per cent. and 20 per cent., but the company's surplus increased by $2,347,614, so that on December 31, 1916, it had a large surplus over its $3,000,000 capital stock. On December 15, 1916, the company issued a circular to the stockholders, saying:

"The company's business for this year has

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shown a *very good increase in volume and a proportionate increase in profits, and it is estimated that by January 1, 1917, the company will have a surplus of over $4,000,000. The

[2] Moody's, p. 1544; Commercial and Financial Chronicle, vol. 94, p. 831; vol. 98, pp. 1005, 1076.

[3] Moody's, p. 1548; Commercial and Financial Chronicle, vol. 94, p. 771; vol. 96, p. 1428; vol. 97, p. 1434; vol. 98, p. 1541.

board feels justified in stating that if the proposition to increase the capital stock is acted on favorably, it will be proper in the near future to declare a cash dividend of 100 per cent. and to allow the stockholders the privilege pro rata according to their holdings, to purchase the new stock at par, the plan being to allow the stockholders, if they desire, to use their cash dividend to pay for the new stock."

The increase of stock was voted. The company then paid a cash dividend of 100 per cent., payable May 1, 1917, again offering to such stockholders the right to subscribe for an equal amount of new stock at par and to apply the cash dividend in payment therefor.

Moody's Manual, describing the transaction with exactness, says first that the stock was increased from $3,000,000 to $6,000,000, "a cash dividend of 100 per cent., payable May 1, 1917, being exchanged for one share of new stock, the equivalent of a 100 per cent. stock dividend." But later in the report giving, as customary in the Manual the dividend record of the company, the Manual says: "A stock dividend of 200 per cent. was paid February 14, 1914, and one of 100 per cent. on May 1, 1197." And in reporting specifically the income account of the company for a series of years ending December 31, covering net profits, dividends paid and surplus for the year, it gives, as the aggregate of dividends for the year 1917, $660,000 (which was the aggregate paid on the quarterly cash dividend—5 per cent. January and April; 6 per cent. July and October), and adds in a note: "In addition a stock dividend of 100 per cent. was paid during the year." [4] The

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Wall Street Journal of *May 2, 1917, p. 2, quotes the 1917 "high" price for Standard Oil of Kentucky as "375 ex stock dividend."

It thus appears that among financiers and investors the distribution of the stock, by whichever method effected, is called a stock dividend; that the two methods by which accumulated profits are legally retained for corporate purposes and at the same time distributed as dividends are recognized by them to be equivalents; and that the financial results to the corporation and to the stockholders of the two methods are substantially the same—unless a difference results from the application of the federal Income Tax Law.

Mrs. Macomber, a citizen and resident of New York, was, in the year 1916, a stockholder in the Standard Oil Company (of California), a corporation organized under the laws of California and having its principal place of business in that state. During that year she received from the company a stock dividend representing profits earned since March 1, 1913. The dividend was paid by direct issue of the stock to her according to the simple method described above, pursued also by the Indiana and Nebraska companies. In 1917 she was taxed under the federal law on the stock dividend so received at its par value of $100 a share, as income received during the year 1916. Such a stock dividend is income, as distinguished from capital, both under the law of New York and under the law of California, because in both states every dividend representing profits is deemed to be income, whether paid in cash or in stock. It had been so held in New York, where the question arose as between life tenant and remainderman, Lowry v. Farmers' Loan & Trust Co., 172 N. Y. 137, 64 N. E. 796; Matter of Osborne, 209 N. Y. 450, 103 N. E. 723, 823, 50 L. R. A. (N. S.) 510, Ann. Cas. 1915A, 298; and also, where the question arose in matters of taxation, People v.

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Glynn, *130 App. Div. 332, 114 N. Y. Supp. 460; Id. 198 N. Y. 605, 92 N. E. 1097. It has been so held in California, where the question appears to have arisen only in controversies between life tenant and remainderman. Estate of Duffill, 183 Pac. 337.

It is conceded that if the stock dividend paid to Mrs. Macomber had been made by the more complicated method pursued by the Standard Oil Company of Kentucky; that is, issuing rights to take new stock pro rata and paying to each stockholder simultaneously a dividend in cash sufficient in amount to enable him to pay for this pro rata of new stock to be purchased—the dividend so paid to him would have been taxable as income, whether he retained the cash or whether he returned it to the corporation in payment for his pro rata of new stock. But it is contended that, because the simple method was adopted of having the new stock issued direct to the stockholders as paid-up stock, the new stock is not to be deemed income, whether she retained it or converted it into cash by sale. If such a different result can flow merely from the difference in the method pursued, it must be because Congress is without power to tax as income of the stockholder either the stock received under the latter method or the proceeds of its sale; for Congress has, by the provisions in the Revenue Act of 1916, expressly declared its purpose to make stock dividends, by whichever method paid, taxable as income.

The Sixteenth Amendment, proclaimed February 25, 1913, declares:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

The Revenue Act of September 8, 1916, c. 463, § 2a, 39 Stat. 756, 757, provided:

[4] Moody's, p. 1547; Commercial and Financial Chronicle, vol. 97, pp. 1589, 1827, 1903; vol. 98, pp. 76, 457; vol. 103, p. 2348. Poor's Manual of Industrials (1918), p. 2240, in giving the "comparative income account" of the company, describes the 1914 dividend as "stock dividend paid (200 per cent.)—$2,000,000," and describes the 1917 dividend as $3,000,000 special cash dividend."

"That the term 'dividends' as used in this
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title shall *be held to mean any distribution made or ordered to be made by a corporation, * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, * * * which stock dividend shall be considered income, to the amount of its cash value."

Hitherto powers conferred upon Congress by the Constitution have been liberally construed, and have been held to extend to every means appropriate to attain the end sought. In determining the scope of the power the substance of the transaction, not its form has been regarded. Martin v. Hunter, 1 Wheat, 304, 326, 4 L. Ed. 97; McCulloch v. Maryland, 4 Wheat. 316, 407, 415, 4 L. Ed. 579; Brown v. Maryland, 12 Wheat. 419, 446, 6 L. Ed. 678; Craig v. Missouri, 4 Pet. 410, 433, 7 L. Ed. 903; Jarrolt v. Moberly, 103 U. S. 580, 585, 587, 26 L. Ed. 492; Legal Tender Case, 110 U. S. 421, 444, 4 Sup. Ct. 122, 28 L. Ed. 204; Lithograph Co. v. Sarony, 111 U. S. 53, 58, 4 Sup. Ct. 279, 28 L. Ed. 349; United States v. Realty Co., 163 U. S. 427, 440, 441, 442, 16 Sup. Ct. 1120, 41 L. Ed. 215; South Carolina v. United States, 199 U. S. 437, 448, 449, 26 Sup. Ct. 110, 50 L. Ed. 261, 4 Ann. Cas. 737. Is there anything in the phraseology of the Sixteenth Amendment or in the nature of corporate dividends which should lead to a departure from these rules of construction and compel this court to hold, that Congress is powerless to prevent a result so extraordinary as that here contended for by the stockholder?

First. The term "income," when applied to the investment of the stockholder in a corporation, had, before the adoption of the Sixteenth Amendment, been commonly understood to mean the returns from time to time received by the stockholder from gains or earnings of the corporation. A dividend received by a stockholder from a corporation may be either in distribution of capital assets or in distribution of profits. Whether it is the one or the other is in no way affected by the medium in which it is paid, nor by the method or means through which the particular thing distributed as a dividend was pro-
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cured. If the *dividend is declared payable in cash, the money with which to pay it is ordinarily taken from surplus cash in the treasury. But (if there are profits legally available for distribution and the law under which the company was incorporated so permits) the company may raise the money by discounting negotiable paper; or by selling bonds, scrip or stock of another corporation then in the treasury; or by selling its own bonds, scrip or stock then in the treasury; or by selling its own bonds, scrip or stock issued expressly for that purpose. How the money shall be raised is wholly a matter of financial management. The manner in which it is raised in no way affects the question whether the dividend received by the stockholder is income or capital; nor can it conceivably affect the question whether it is taxable as income.

Likewise whether a dividend declared payable from profits shall be paid in cash or in some other medium is also wholly a matter of financial management. If some other medium is decided upon, it is also wholly a question of financial management whether the distribution shall be, for instance, in bonds, scrip or stock of another corporation or in issues of its own. And if the dividend is paid in its own issues, why should there be a difference in result dependent upon whether the distribution was made from such securities then in the treasury or from others to be created and issued by the company expressly for that purpose? So far as the distribution may be made from its own issues of bonds, or preferred stock created expressly for the purpose, it clearly would make no difference in the decision of the question whether the dividend was a distribution of profits, that the securities had to be created expressly for the purpose of distribution. If a dividend paid in securities of that nature represents a distribution of profits Congress may, of course, tax it as income of the stockholder. Is the result different where the security distributed is common stock?

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*Suppose that a corporation having power to buy and sell its own stock, purchases, in the interval between its regular dividend dates, with moneys derived from current profits, some of its own common stock as a temporary investment, intending at the time of purchase to sell it before the next dividend date and to use the proceeds in paying dividends, but later, deeming it inadvisable either to sell this stock or to raise by borrowing the money necessary to pay the regular dividend in cash, declares a dividend payable in this stock; can any one doubt that in such a case the dividend in common stock would be income of the stockholder and constitutionally taxable as such? See Green v. Bissell, 79 Conn. 547, 65 Atl. 1056, 8 L. R. A. (N. S.) 1011, 118 Am. St. Rep. 156, 9 Ann. Cas. 287; Leland v. Hayden, 102 Mass. 542. And would it not likewise be income of the stockholder subject to taxation if the purpose of the company in buying the stock so distributed had been from the beginning to take it off the market and distribute it among the stockholders as a dividend, and the company actually did so? And proceeding a short step further: Suppose that a corporation decided to capitalize some of its accumulated profits by creating additional common stock and selling the same to raise working capital, but after the stock has been issued and certificates therefor are deliver-

ed to the bankers for sale, general financial conditions make it undesirable to market the stock and the company concludes that it is wiser to husband, for working capital, the cash which it had intended to use in paying stockholders a dividend, and, instead, to pay the dividend in the common stock which it had planned to sell; would not the stock so distributed be a distribution of profits—and hence, when received, be income of the stockholder and taxable as such? If this be conceded, why should it not be equally income of the stockholder, and taxable as such, if the common stock created by capitalizing profits, had been originally created for the

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express purpose of being dis*tributed as a dividend to the stockholder who afterwards received it?

Second. It has been said that a dividend payable in bonds or preferred stock created for the purpose of distributing profits may be income and taxable as such, but that the case is different where the distribution is in common stock created for that purpose. Various reasons are assigned for making this distinction. One is that the proportion of the stockholder's ownership to the aggregate number of the shares of the company is not changed by the distribution. But that is equally true where the dividend is paid in its bonds or in its preferred stock. Furthermore, neither maintenance nor change in the proportionate ownership of a stockholder in a corporation has any bearing upon the question here involved. Another reason assigned is that the value of the old stock held is reduced approximately by the value of the new stock received, so that the stockholder after receipt of the stock dividend has no more than he had before it was paid. That is equally true whether the dividend be paid in cash or in other property, for instance, bonds, scrip or preferred stock of the company. The payment from profits of a large cash dividend, and even a small one, customarily lowers the then market value of stock because the undivided property represented by each share has been correspondingly reduced. The argument which appears to be most strongly urged for the stockholders is, that when a stock dividend is made, no portion of the assets of the company is thereby segregated for the stockholder. But does the issue of new bonds or of preferred stock created for use as a dividend result in any segregation of assets for the stockholder? In each case he receives a piece of paper which entitles him to certain rights in the undivided property. Clearly segregation of assets in a physical sense is not an essential of income. The year's gains of a partner is taxable as income, although there,

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likewise, no *segregation of his share in the gains from that of his partners is had.

The objection that there has been no segregation is presented also in another form. It is argued that until there is a segregation, the stockholder cannot know whether he has really received gains; since the gains may be invested in plant or merchandise or other property and perhaps be later lost. But is not this equally true of the share of a partner in the year's profits of the firm or, indeed, of the profits of the individual who is engaged in business alone? And is it not true, also, when dividends are paid in cash? The gains of a business, whether conducted by an individual, by a firm or by a corporation, are ordinarily reinvested in large part. Many a cash dividend honestly declared as a distribution of profits, proves later to have been paid out of capital, because errors in forecast prevent correct ascertainment of values. Until a business adventure has been completely liquidated, it can never be determined with certainty whether there have been profits unless the returns at least exceeded the capital originally invested. Business men, dealing with the problem practically, fix necessarily periods and rules for determining whether there have been net profits—that is, income or gains. They protect themselves from being seriously misled by adopting a system of depreciation charges and reserves. Then, they act upon their own determination, whether profits have been made. Congress in legislating has wisely adopted their practices as its own rules of action.

Third. The Government urges that it would have been within the power of Congress to have taxed as income of the stockholder his pro rata share of undistributed profits earned, even if no stock dividend representing it had been paid. Strong reasons may be assigned for such a view. See The Collector v. Hubbard, 12 Wall. 1, 20 L. Ed. 272. The undivided share of a partner in the year's undistribut-

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ed profits of his firm *is taxable as income of the partner, although the share in the gain is not evidenced by any action taken by the firm. Why may not the stockholder's interest in the gains of the company? The law finds no difficulty in disregarding the corporate fiction whenever that is deemed necessary to attain a just result. Linn Timber Co. v. United States, 236 U. S. 574, 35 Sup. Ct. 440, 59 L. Ed. 725. See Morawetz on Corporations (2d Ed.) §§ 227-231; Cook on Corporations (7th Ed.) §§ 663, 664. The stockholder's interest in the property of the corporation differs, not fundamentally but in form only, from the interest of a partner in the property of the firm. There is much authority for the proposition that, under our law, a partnership or joint stock company is just as distinct and palpable an entity in the idea of the law, as distinguished from the individuals composing it, as is a cor-

poration.[5] No reason appears, why Congress, in legislating under a grant of power so comprehensive as that authorizing the levy of an income tax, should be limited by the particular view of the relation of the stockholder to the corporation and its property which may, in the absence of legislation, have been taken by this court. But we have no occasion to decide the question whether Congress might have taxed to the stockholder his undivided share of the corporation's earnings. For Congress has in this act limited the income tax to that share of the stockholder in the earnings which is, in effect, distributed by means of the stock dividend paid. In other words to render the stockholder taxable there must be both earnings made *and* a dividend paid. Neither earnings without dividend—nor a dividend

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without earnings—subjects the *stockholder to taxation under the Revenue Act of 1916.

Fourth. The equivalency of all dividends representing profits, whether paid in cash or in stock, is so complete that serious question of the taxability of stock dividends would probably never have been made, if Congress had undertaken to tax only those dividends which represented profits earned during the year in which the dividend was paid or in the year preceding. But this court, construing liberally, not only the constitutional grant of power, but also the revenue act of 1913, held that Congress might tax, and had taxed, to the stockholder dividends received during the year, although earned by the company long before; and even prior to the adoption of the Sixteenth Amendment. Lynch v. Hornby, 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149.[6] That rule, if indiscriminatingly applied to all stock dividends representing profits earned, might, in view of corporate practice, have worked considerable hardship, and have raised serious questions. Many corporations, without legally capitalizing any part of their profits, had assigned definitely some part or all of the annual balances remaining after paying the usual cash dividends, to the uses to which permanent capital is ordinarily applied. Some of the corporations doing this, transferred such balances on their books to "surplus" account—distinguishing between such permanent "surplus" and the "undivided profits" account. Other corporations, without this formality, had assumed that the annual accumulating balances carried as undistributed profits were to be treated as capital permanently invested in the business. And still others, without definite assumption

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of any kind, had *so used undivided profits for capital purposes. To have made the revenue law apply retroactively so as to reach such accumulated profits, if and whenever it should be deemed desirable to capitalize them legally by the issue of additional stock distributed as a dividend to stockholders, would have worked great injustice. Congress endeavored in the Revenue Act of 1916 to guard against any serious hardship which might otherwise have arisen from making taxable stock dividends representing accumulated profits. It did not limit the taxability to stock dividends representing profits earned within the tax year or in the year preceding; but it did limit taxability to such dividends representing profits earned since March 1, 1913. Thereby stockholders were given notice that their share also in undistributed profits accumulating thereafter was at some time to be taxed as income. And Congress sought by section 3 (Comp. St. 1918, Comp. St. Ann. Supp. 1919, § 6336c) to discourage the postponement of distribution for the illegitimate purpose of evading liability to surtaxes.

Fifth. The decision of this court, that earnings made before the adoption of the Sixteenth Amendment, but paid out in cash dividend after its adoption, were taxable as income of the stockholder, involved a very liberal construction of the amendment. To hold now that earnings both made and paid out after the adoption of the Sixteenth Amendment cannot be taxed as income of the stockholder, if paid in the form of a stock dividend, involves an exceedingly narrow construction of it. As said by Mr. Chief Justice Marshall in Brown v. Maryland, 12 Wheat. 419, 446 (6 L. Ed. 678):

> "To construe the power so as to impair its efficacy, would tend to defeat an object, in the attainment of which the American public took, and justly took, that strong interest which arose from a full conviction of its necessity."

No decision heretofore rendered by this court requires us to hold that Congress, in pro-

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viding for the taxation of *stock dividends, exceeded the power conferred upon it by the Sixteenth Amendment. The two cases mainly relied upon to show that this was beyond the power of Congress are Towne v. Eisner, 245 U. S. 418, 38 Sup. Ct. 158, 62 L. Ed. 372, L. R. A. 1918D, 254, which involved a question not of constitutional power but of statutory construction, and Gibbons v. Ma-

[5] See Some Judicial Myths, by Francis M. Burdick, 22 Harvard Law Review, 393, 394-396; The Firm as a Legal Person, by William Hamilton Cowles, 57 Cent. L. J., 343, 348; The Separate Estates of Non-Bankrupt Partners, by J. D. Brannan, 20 Harvard Law Review, 589-592. Compare Harvard Law Review, vol. 7, p. 426; vol. 14, p. 222; vol. 17, p. 194.

[6] The hardship supposed to have resulted from such a decision has been removed in the Revenue Act of 1916 as amended, by providing in section 31b (Comp. St. 1918, Comp. St. Ann. Supp. 1919, § 6336½) that such cash dividends shall thereafter be exempt from taxation, if before they are made all earnings made since February 28, 1913, shall have been distributed. Act Oct. 3, 1917, c. 63, § 1211, 40 Stat. 338, Act Feb. 24, 1919, c. 18, § 201(b), 40 Stat. 1059 (Comp. St. Ann. Supp. 1919, § 6336½b).

hon, 136 U. S. 549, 10 Sup. Ct. 1057, 34 L. Ed. 525, which involved a question arising between life tenant and remainderman. So far as concerns Towne v. Eisner we have only to bear in mind what was there said (245 U. S. 425, 38 Sup. Ct. 159, 62 L. Ed. 372, L. R. A. 1918D, 254): "But it is not necessarily true that income means the same thing in the Constitution and the [an] act." [1] Gibbons v. Mahon is even less an authority for a narrow construction of the power to tax incomes conferred by the Sixteenth Amendment. In that case the court was required to determine how, in the administration of an estate in the District of Columbia, a stock dividend, representing profits, received after the decedent's death, should be disposed of as between life tenant and remainderman. The question was in essence: What shall the intention of the testator be presumed to have been? On this question there was great diversity of opinion and practice in the courts of English-speaking countries. Three well-defined rules were then competing for acceptance; two of these involves an arbitrary rule of distribution, the third equitable apportionment. See Cook on Corporations (7th Ed.) §§ 552–558.

1. The so-called English rule, declared in 1799, by Brander v. Brander, 4 Ves. Jr. 800,

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that a dividend rep*resenting profits, whether in cash, stock or other property, belongs to the life tenant if it was a regular or ordinary dividend, and belongs to the remainderman if it was an extraordinary dividend.

2. The so-called Massachusetts rule, declared in 1868 by Minot v. Paine, 99 Mass. 101, 96 Am. Dec. 705, that a dividend representing profits, whether regular, ordinary or extraordinary, if in cash belongs to the life tenant, and if in stock belongs to the remainderman.

3. The so-called Pennsylvania rule declared in 1857 by Earp's Appeal, 28 Pa. 368, that where a stock dividend is paid, the court shall inquire into the circumstances under which the fund had been earned and accumulated out of which the dividend, whether a regular, an ordinary or an extraordinary one, was paid. If it finds that the stock dividend was paid out of profits earned since the decedent's death, the stock dividend belongs to the life tenant; if the court finds that the stock dividend was paid from capital or from profits earned before the decedent's death, the stock dividend belongs to the remainderman.

This court adopted in Gibbons v. Mahon as the rule of administration for the District of Columbia the so-called Massachusetts rule, the opinion being delivered in 1890 by Mr. Justice Gray. Since then the same question has come up for decision in many of the states. The so-called Massachusetts rule, although approved by this court, has found favor in only a few states. The so-called Pennsylvania rule, on the other hand, has been adopted since by so many of the states (including New York and California), that it has come to be known as the "American rule." Whether, in view of these facts and the practical results of the operation of the two rules as shown by the experience of the 30 years which have elapsed since the decision in Gibbons v. Mahon, it might be desirable for this court to reconsider the question there decid-

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ed, as *some other courts have done (see 29 Harvard Law Review, 551), we have no occasion to consider in this case. For, as this court there pointed out (136 U. S. 560, 1059 [34 L. Ed. 525]), the question involved was one "between the owners of successive interests in particular shares," and not, as in Bailey v. Railroad Co., 22 Wall. 604, 22 L. Ed. 840, a question "between the corporation and the government, and [which] depended upon the terms of a statute carefully framed to prevent corporations from evading payment of the tax upon their earnings."

We have, however, not merely argument; we have examples which should convince us that "there is no inherent, necessary and immutable reason why stock dividends should always be treated as capital." Tax Commissioner v. Putnam, 227 Mass. 522, 533, 116 N. E. 904, L. R. A. 1917F, 806. The Supreme Judicial Court of Massachusetts has steadfastly adhered, despite ever-renewed protest, to the rule that every stock dividend is, as between life tenant and remainderman, capital and not income. But in construing the Massachusetts Income Tax Amendment, which is substantially identical with the federal amendment, that court held that the Legislature was thereby empowered to levy an income tax upon stock dividends representing profits. The courts of England have, with some relaxation, adhered to their rule that every extraordinary dividend is, as between life tenant and remainderman, to be deemed capital. But in 1913 the Judicial Committee of the Privy Council held that a stock dividend representing accumulated profits was taxable like an ordinary cash dividend, Swan Brewery Company, Limited v. The King, L. R. 1914 A. C. 231. In dismissing the appeal these words of the Chief Justice of the Supreme Court of Western Australia were quoted (page 236) which show that the facts involved were identical with those in the case at bar:

"Had the company distributed the £101,450 among the shareholders and had the shareholders repaid such sums to the company as the price of the 81,160 new shares, the duty on the £101,-

[1] Compare Rugg, C. J., in Tax Commissioner v. Putnam, 227 Mass. 522, 533, 116 N. E. 904, 910 (L. R. A., 1917F, 806): "However strong such an argument might be when urged as to the interpretation of a statute, it is not of prevailing force as to the broad considerations involved in the interpretation of an amendment to the Constitution adopted under the conditions preceding and attendant upon the ratification of the forty-fourth amendment."

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450 *would clearly have been payable. Is not this virtually the effect of what was actually done? I think it is."

Sixth. If stock dividends representing profits are held exempt from taxation under the Sixteenth Amendment, the owners of the most successful businesses in America will, as the facts in this case illustrate, be able to escape taxation on a large part of what is actually their income. So far as their profits are represented by stock received as dividends they will pay these taxes not upon their income but only upon the income of their income. That such a result was intended by the people of the United States when adopting the Sixteenth Amendment is inconceivable. Our sole duty is to ascertain their intent as therein expressed.[8] In terse, comprehensive language befitting the Constitution, they empowered Congress "to lay and collect taxes on incomes from whatever source derived." They intended to include thereby everything which by reasonable understanding can fairly be regarded as income. That stock dividends representing profits are so regarded, not only by the plain people, but by investors and financiers, and by most of the courts of the country, is shown, beyond peradventure, by their acts and by their utterances. It seems to me clear, therefore, that Congress possesses the power which it exercised to make dividends representing profits, taxable as income, whether the medium in which the dividend is paid be cash or stock, and that it may define, as it has done,

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what dividends repre*senting profits shall be deemed income. It surely is not clear that the enactment exceeds the power granted by the Sixteenth Amendment. And, as this court has so often said, the high prerogative of declaring an act of Congress invalid, should never be exercised except in a clear case.[9]

"It is but a decent respect due to the wisdom, the integrity and the patriotism of the legislative body, by which any law is passed, to presume in favor of its validity, until its violation of the Constitution is proved beyond all reasonable doubt." Ogden v. Saunders, 12 Wheat. 213, 269, 6 L. Ed. 606.

Mr. Justice CLARKE concurs in this opinion.

[8] Compare Rugg, C. J., Tax Commissioner v. Putnam, 227 Mass. 522, 524, 116 N. E. 904, 910 (L. R. A. 1917F, 806): "It is a grant from the sovereign people and not the exercise of a delegated power. It is a statement of general principles and not a specification of details. Amendments to such a charter of government ought to be construed in the same spirit and according to the same rules as the original. It is to be interpreted as the Constitution of a state and not as a statute or an ordinary piece of legislation. Its words must be given a construction adapted to carry into effect its purpose."

[9] "It is our duty, when required in the regular course of judicial proceedings, to declare an act of Congress void if not within the legislative power of the United States; but this declaration should never be made except in a clear case. Every possible presumption is in favor of the validity of a statute, and this continues until the contrary is shown beyond a rational doubt. One branch of the government cannot encroach on the domain of another without danger. The safety of our institutions depends in no small degree on a strict observance of this salutary rule." The 'Sinking Fund Cases, 99 U. S. 700, 718, 25 L. Ed. 496 (1878). See also Legal Tender Cases, 12 Wall. 457, 531, 20 L. Ed. 287 (1870); Trade Mark Cases, 100 U. S. 82, 96, 25 L. Ed. 550 (1879). See American Doctrine of Constitutional Law by James B. Thayer, 7 Harvard Law Review, 129, 142.

"With the exception of the extraordinary decree rendered in the Dred Scott Case, * * * all of the acts or the portions of the acts of Congress invalidated by the courts before 1868 related to the organization of courts. Denying the power of Congress to make notes legal tender seems to be the first departure from this rule." Haines, American Doctrine of Judicial Supremacy, p. 288. The first legal tender decision was overruled in part two years later (1870), Legal Tender Cases, 12 Wall. 457, 20 L. Ed. 287; and again in 1883, Legal Tender Case, 110 U. S. 421, 4 Sup. Ct. 122, 28 L. Ed. 204.

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Fed. Tax. Fin. Instruments & Transactions ¶ 1.01

***1 Federal Taxation of Financial Instruments & Transactions**

October 2020

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Part I. Equity Investments

Chapter 1. Stock Distributions Under Section 305

1.01 HISTORICAL BACKGROUND

The tax treatment of stock dividends raises a number of complex issues that date back to the earliest days of the income tax itself. These issues arise, on the one hand, because a stock dividend in certain instances represents the mere division of a shareholder's equity interest into smaller units, without any change in the overall value of that interest. For example, assume that a corporation having only common stock outstanding makes a distribution of additional common stock to its shareholders. No assets are severed from the corporation in this instance, and the distribution merely gives each shareholder more shares of stock reflecting the same equity interest. In essence, the shareholders' claim in the earnings and net assets of the corporation remains the same. Accordingly, stock dividends of this nature are not generally viewed as income.

In other cases, however, a stock dividend can change a shareholder's interest in the earnings or assets of the distributing corporation. For instance, suppose a corporation declares a dividend payable in stock but also gives its shareholders an election to receive cash or other property in lieu of the stock. The shareholder who receives stock is in the same position as if he received a taxable cash dividend and purchased additional stock with the proceeds. The end result is that the shareholder's equity in the corporation has increased vis-à -vis the shareholders who received cash dividends. Accordingly, income is generally thought to arise on the receipt of the stock.

The tax treatment of stock dividends was litigated in several early decisions. The outcome of these cases turned on whether the stock dividend changed the proportionate interests of the shareholders in the earnings or assets of the corporation (i.e., a proportionate interest test developed). This proportionate interest test was temporarily eliminated in 1954 when Section 305 of the Internal Revenue Code (the Code) was enacted. It made its reappearance, however, with the overhaul of Section 305 in 1969, albeit in a much more involved and complicated manner. Indeed, while Section 305 was fairly simple and straightforward in its early stages, it has evolved into one of the most difficult and challenging Sections of the Code.

1.01[1] Development of the Proportionate Interest Test Under Case Law

The Revenue Act of 1913 provided generally that the term “income” for tax purposes included the receipt of a dividend. [1] This initial legislation, however, did not specifically address the treatment of a stock dividend. Thus, in *Towne v. Eisner,* [2] the government attempted to tax the receipt of a common stock dividend that was made, pro rata, to the holders of a corporation's

outstanding common stock. The Supreme Court held that such a dividend was not income to the recipient, stating its reasons as follows:

***2** A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased....The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones. [3]

Congress sought to reverse the *Towne* result by providing in the Revenue Act of 1916 that receipt of a stock dividend constituted taxable income. [4] However, in the now famous *Eisner v. Macomber* [5] decision, the Supreme Court reaffirmed its view that a pro rata distribution of common stock on outstanding common stock did not create taxable income. As in *Towne,* the Court reasoned that the payment of such a dividend did not sever any assets from the corporation, nor did it alter the preexisting proportionate interest of the shareholders in the corporation. [6] The common shareholders' claim on the earnings and assets of the corporation, that were not already dedicated to the preferred stock, remained the same.

Although the *Macomber* court focused only on a pro rata distribution of *common on common,* Congress interpreted *Macomber* broadly as exempting all stock dividends from tax. Accordingly, it provided in the Revenue Act of 1921, without exception, that stock dividends were not taxable income. [7] Congress, however, failed to appreciate the fact that the Court had only addressed the case where the stock distribution did not alter the shareholders' interest in the earnings or assets of the distributing corporation. As a result, all stock dividends remained entirely exempt from tax from 1921 until 1936, when the Supreme Court had the opportunity, in *Koshland v. Helvering,* [8] to clarify the scope of its earlier decisions.

In *Koshland,* the taxpayer had purchased preferred stock that entitled the holder to a fixed and limited amount on the liquidation of the issuing corporation. Holders of the corporation's common stock were entitled to all of the assets that remained after payment of the preferred. The corporation elected to pay dividends on the preferred in the form of common stock rather than cash (even though the corporation had sufficient reserves of cash). The ultimate issue in the case turned on whether the stock dividend was taxable, [9] and in this regard, the Court properly noted that the dividend resulted in an increase in the taxpayer's proportionate interest in the corporation. As a preferred shareholder, the taxpayer had received rights to the corporation's earnings and assets that previously were not enjoyed, and this increase arose at the expense of the existing common shareholders. This fact made the case distinguishable from *Macomber,* where the shareholders were merely dividing the same residual equity into smaller pieces. Accordingly, under the proportionate interest test, the receipt of a common stock dividend on preferred stock constituted income.

***3** Congress responded to *Koshland* in the Revenue Act of 1936 by providing that a stock dividend was taxable only to the extent that it constituted income within the meaning of the Sixteenth Amendment to the Constitution. [10] In effect, Congress had determined that the courts should decide when stock dividends were taxable. Accordingly, from 1936 to 1954 the Supreme Court developed and refined the proportionate interest test as a means of separating taxable from nontaxable stock distributions. For instance, in *Helvering v. Gowran,* [11] the Court held that a distribution of preferred stock to existing common shareholders, where the same class of preferred stock was already outstanding, was taxable, because the common shareholders increased their interest in the corporation's assets through the liquidation preference inherent in the preferred stock. Conversely, in *Strassburger v. Commissioner,* [12] a pro rata dividend of preferred stock on common, where preferred was *not* previously outstanding, was held to be nontaxable, because the distribution did not alter the recipient shareholder's interest in the net assets of the corporation. [13]

The Revenue Act of 1936, however, contained a provision under which a stock dividend was taxable if the shareholder could elect to receive property instead of the stock. [14] This provision appeared to be based on constructive receipt principles—that

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income that is made available without restriction cannot be ignored. [15] Thus, the presence of an election to receive cash or stock rendered the receipt of stock taxable. This provision has remained in the law since that time.

1.01[2] Congress Eliminates the Test in 1954

Congress subsequently came to believe that receipt of a stock dividend should not be taxable, even if it altered the proportionate interest of the shareholders. Thus, when the Code was revamped in 1954, this principle was inserted into new Section 305(a), which stated broadly that income did not include any stock distribution made by a corporation to its shareholders with respect to their stock. Section 305(a) reflects a policy decision that the proper time to impose tax is not when the stock is received, but when distributions on the stock are received. [16]

Only two exceptions to this general rule were provided. The first exception, which was carried over from the 1936 legislation, provided that a stock dividend would be taxable if any shareholder could elect to receive the distribution in either stock or property. Under the second exception, a stock distribution was taxable if it was made to satisfy dividend arrearages on preferred stock for the current or prior taxable year. Other than these two exceptions, stock dividends were considered to be tax free, even if the recipient's equity stake in the corporation had increased as a result of the dividend. Thus, the proportionate interest test had been eliminated. [17]

1.01[3] Reinstatement in 1969

***4** Although the 1954 version of Section 305 taxed shareholders on the elective receipt of stock, many corporations devised methods whereby their shareholders, in effect, could be given a choice between receiving cash dividends or increasing their proportionate interests in the corporation, without incurring tax under Section 305. These methods generally produced the same effect as if the shareholder had received a cash dividend and reinvested it in the corporation. In one well-publicized situation, Citizens Utility Company created two classes of stock—one paying stock dividends and one paying cash dividends. The dividend-paying class was held by shareholders seeking to increase their equity position in the corporation, while the other class was held by those interested in cash. This capital structure produced the same effect as the prohibited election because shareholders could exchange one class of stock for the other, tax free, under Section 1036 when they wished to change the medium of payment. Thus, a taxable distribution could be converted into a tax-free distribution under Section 305(a).

Treasury sought to eliminate these perceived abuses through regulations issued under the 1954 version of Section 305. Although these regulations were finalized in 1969, many considered them to be aggressive and perhaps invalid. Moreover, the regulations did not capture all of the known schemes for avoiding Section 305. Accordingly, Congress revised and significantly expanded Section 305 in the Tax Reform Act of 1969. [18] The 1969 version of Section 305, with its subsequent amendments and regulations, is discussed in the remainder of this chapter.

Footnotes

1 Revenue Act of 1913, § II.B, 38 Stat. 114.
2 Towne v. Eisner, 245 US 418 (1918).
3 Id. at 426, quoting from Gibbons v. Mahon, 136 US 549, 559, 560 (1890).

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4 Revenue Act of 1916, § 2(a), 39 Stat. 756.

5 Eisner v. Macomber, 252 US 189 (1920).

6 Id. at 211.

7 Revenue Act of 1921, § 201(d), 42 Stat. 227. HR Rep. No. 350, 67th Cong., 1st Sess. 8 (1921); S. Rep. No. 275, 67th Cong., 1st Sess. 9 (1921).

8 Koshland v. Helvering, 298 US 441 (1936).

9 The shareholder in *Koshland* had redeemed the preferred stock, and the precise question at hand concerned the shareholder's basis in the redeemed stock. Under then-existing Treasury regulations, if the dividend represented a return of capital instead of income, the basis of the outstanding preferred stock would be allocated between that stock and the new common stock received. An allocation of this nature would increase the amount of gain on the redemption. Reg. § 74, arts. 58, 600, 628. As indicated in the text, the Court found that the dividend was income within the meaning of the Sixteenth Amendment, but that Congress had failed to tax it upon receipt. As a result, the regulation could not be applied to allocate basis away from the redeemed stock.

10 Revenue Act of 1936, § 115(f)(1), 49 Stat. 1648.

11 Helvering v. Gowran, 302 US 238 (1937), reh'g denied, 302 US 781 (1938).

12 Strassburger v. Comm'r, 124 F2d 315 (2d Cir. 1941), rev'd sub nom. Helvering v. Sprouse, 318 US 604, 607 (1943).

13 This case represents the classic preferred stock bailout that led to the enactment of Section 306 in 1954.

14 Revenue Act of 1936, § 115(f)(2).

15 See Reg. § 1.451-2(a) for one articulation of the constructive receipt doctrine. See also Rev. Rul. 60-31, 1960-1 CB 174.

16 However, in 1954 Congress also added Section 306 to serve as a backstop should taxpayers attempt to distribute preferred stock tax free under Section 305, and then subsequently sell or redeem that stock at favorable capital gain rates.

17 The legislative history confirms Congress's intent to eliminate the proportionate interest test. HR Rep. No. 1337, 83d Cong., 2d Sess. 35, A81 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 44, 241 (1954).

18 Tax Reform Act of 1969, Pub L. No. 91-172, 91st Cong., 1st Sess. § 421, 83 Stat. 487. See HR Rep. No. 413, 91st Cong., 1st Sess., pt. 1, 111–116 (1969) (hereinafter House-Report); S. Rep. No. 552, 91st Cong., 1st Sess. 150–155 (1969) (hereinafter Senate Report).

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***1 Federal Taxation of Financial Instruments & Transactions**

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Part I. Equity Investments

Chapter 1. Stock Distributions Under Section 305

1.02 OVERVIEW OF CURRENT SCHEME OF TAXATION

The current version of Section 305, first set in place in 1969, can be extremely difficult to understand and apply. A significant part of the problem lies in the fact that the statute is not drafted in a clear, logical manner. The regulations under Section 305 add to the confusion, because many key principles are not spelled out, and those that can be discerned are often contradicted by the regulations themselves. The material below is intended to provide an overview of Section 305 and its operation. Subsequent paragraphs will analyze these provisions in greater detail.

1.02[1] Tax-Free Stock Distributions

Section 305(a) continues the general rule originating with *Towne* and *Macomber* that a distribution by a corporation of its own stock is not taxable. If Section 305(a) tax-free treatment applies, the shareholder must allocate the basis of the outstanding stock (the old stock) between the old stock and the new stock received. This allocation is generally made based on the relative fair market values of the old and new stock on the date of distribution. [19] In addition, the holding period of the new stock includes the period for which the shareholder held the old stock. [20] If the old stock is composed of blocks of stock having different bases in the hands of the shareholder, then the basis and holding period of each of the old blocks must be allocated to the new stock in proportion to the relative fair market values of the old blocks. [21] Finally, the earnings and profits of the distributing corporation are not reduced on account of the distribution, [22] and the recipient does not increase its earnings and profits on receiving the distribution (assuming it is a corporation). [23]

1.02[2] Taxable Stock Distributions

The general rule of Section 305(a) is often overpowered by a series of complex, overlapping exceptions to tax-free treatment contained in Section 305(b). In addition, Section 305(c) authorizes the government to issue regulations that, in certain instances, create a *deemed* distribution of stock that may be taxable under Section 305(b). The complexity of Sections 305(b) and 305(c) has drawn such attention, and the efforts to avoid taxation under these provisions have become so great that the general rule of Section 305(a) is often overlooked. [24] Corporations contemplating a tax-free stock distribution must carefully analyze Sections

305(b) and 305(c), and the regulations thereunder, to insure the distribution is indeed tax free. A brief overview of these provisions is found below.

1.02[2][a] Types of Distributions

***2** Section 305(b) lists five types of stock distributions that are taxable. Four of these exceptions are designed to tax stock dividends when a shift in the proportionate interest of the shareholders has occurred or potentially may occur (i.e., the interest of some shareholders in the earnings or assets of the corporation has increased, while the interest of other shareholders has decreased or been diluted). [25] The four exceptions are as follows:

- Section 305(b)(1), *which provides that a stock dividend is taxable if, at the election of* any *shareholder, the dividend can be paid in property instead of stock;*

- Section 305(b)(2), *which provides that a stock dividend is taxable if the result of the distribution is that some shareholders receive property while other shareholders increase their interest in the earnings or assets of the corporation;*

- Section 305(b)(3), *which taxes a stock dividend on common stock where, as a result of the distribution, some common shareholders receive common stock and other common shareholders receive preferred stock; and*

- Section 305(b)(5), *which taxes a dividend payable in convertible preferred stock, where the corporation cannot establish that the distribution will not have the disproportionate result described in Section 305(b)(2).*

In applying these provisions, any security convertible into stock or any right to acquire stock is treated as outstanding stock, [26] and the holder of the instrument is treated as a shareholder. [27] Thus, a distribution of rights to acquire stock is treated as a distribution of stock that will become a taxable distribution if, for example, the corporation also distributes cash to another group of shareholders.

The fifth type of taxable distribution is described in Section 305(b)(4), which treats any distribution on preferred stock as a taxable distribution. This exception reflects Congress's policy decision that all dividends on preferred stock should be taxed, whether paid in the form of cash or stock. [28] The regulations, however, appear to take a different policy approach by suggesting that stock dividends are taxable because one group of shareholders, the preferred shareholders, experience an increase in their equity interest by virtue of the stock dividend. [29]

1.02[2][b] Creating Deemed Distributions of Stock

As indicated above, when Congress amended Section 305 in 1969, it was aware that a corporation could arrange its capital structure so that its shareholders could increase their equity interest in the corporation without having to make an *actual* distribution of stock. If successful, Section 305 would be avoided, as illustrated in the following example.

Example 1-1

A corporation designs its capital structure so that when cash dividends are paid on its common stock, the conversion ratio on its outstanding convertible preferred stock is increased. By increasing the conversion ratio, the holder of the convertible security is entitled to receive more stock upon conversion, just as if stock (or rights to acquire stock) had been distributed in lieu of cash.

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Thus, a potential increase in the proportionate interests of the convertible holder is set in place, to be realized upon conversion. However, the change would not be taxable to the preferred shareholder under the 1954 version of Section 305, given the absence of an actual stock distribution. [30]

1.02[2][b][i] The statutory provisions.

***3** Congress added Section 305(c) to the Code in 1969 to authorize the Treasury to issue regulations where transactions having a disproportionate effect would be taxable under Sections 305 and 301, even though they did not involve an *actual* distribution of stock. Section 305(c) and the regulations thereunder accomplish this task by creating a *deemed* distribution of stock, which is considered to be received by the shareholder experiencing the increase in proportionate interest. [31] This deemed distribution of stock must then run the gauntlet of Section 305(b) to determine if it is taxable.

To address the scheme outlined in Example 1-1, Section 305(c) lists "a change in conversion ratio" as one of the transactions that can give rise to a deemed distribution. Thus, an increase in the conversion ratio can be treated as a distribution of stock to the security holder, while, on the other hand, a decrease in the ratio can be viewed as a stock distribution to the holders of the stock into which the instrument is convertible. Section 305(d)(1) provides a necessary complement to this scheme by providing that "stock" for Section 305 purposes includes rights to acquire stock, while under Section 305(d)(2), the term "shareholder" includes the holder of rights or convertible securities.

In addition, Congress was also aware in 1969 that preferred stock could be designed so that it paid no dividends currently, but had a redemption price that greatly exceeded the amount received upon issuance. Such stock (sometimes referred to as "discount preferred stock") has the effect of paying stock dividends over the term of the stock. For example, a corporation could issue preferred stock for $100 per share that pays no dividends but that may be redeemed in twenty years for $200. The effect is the same as if the corporation distributed preferred stock equal to 5 percent of the original stock each year during the twenty-year period in lieu of cash dividends, with all of the stock then being exchanged for cash at the redemption date. [32] Section 305(c) authorizes regulations to create deemed distributions of stock that, in effect, amortize the difference between the redemption price and the issue price of the stock. As discussed below, these deemed distributions are taxable under Section 305(b)(4). [33]

Similarly, the shareholders' proportionate interests in a corporation could be altered without an actual distribution of stock through the redemption of some, but not all, of the shareholders. For instance, if redemptions were made periodically over time in small increments, the proportionate interests of the nonredeeming shareholders would gradually increase, while the redeemed shareholders would receive cash or other property as their interest gradually decreased. Accordingly, Section 305(c)provides that a redemption treated as a Section 301 distribution can give rise to a deemed distribution of stock. The stock distribution is considered made to the nonredeeming shareholders who experience an increase in their proportionate equity interests in the corporation.

***4** Other transactions that can involve a deemed or constructive distribution of stock under Section 305(c) include:

- *1. A change in redemption price, where an increase in the redemption price of stock can be treated as a constructive distribution of stock; and*

- *2. Any transaction, including a recapitalization, having a similar effect on the interest of any shareholder.*

In summary, Section 305(c) provides that a change in conversion ratio, a change in redemption price, the presence of a redemption premium, a redemption treated as a distribution to which Section 301 applies, or any transaction (including a

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recapitalization) having a similar effect may give rise to a deemed distribution of stock with respect to any shareholder whose proportionate interest in the earnings or assets of the corporation is increased. [34] In addition, Congress amended Section 305(c) in 1990 to clarify when a deemed distribution on discount preferred stock would arise and how that discount was to be amortized. [35] In 1993, Section 305(e) was added to the Code to address the treatment of stripped preferred stock. [36] In general, these amendments bring the treatment of preferred stock closer to debt.

1.02[2][b][ii] The implementing regulations.

The regulations confirm that a deemed distribution of stock can arise in any one of the situations listed in Section 305(c), [37] and further provide that the deemed distribution will be taxable under Sections 305(b) and 301 if (1) the proportionate interest of any shareholder in the earnings or assets of the corporation is increased by the transaction and (2) the deemed distribution has one of the proscribed results described in Section 305(b)(2), Section 305(b)(3), Section 305(b)(4) or Section 305(b)(5). As indicated above, [38] this constructive distribution is deemed to be made by the corporation to the shareholder experiencing the increased interest. Depending upon the facts presented, the distribution is deemed to be made in common or preferred stock. [39]

The regulations under Section 305(c) also provide that a change in the conversion ratio of convertible preferred stock or debt under a "bona fide and reasonable adjustment formula" will generally not give rise to a deemed distribution if the change prevents dilution in the interests of the holders of the convertible instrument. [40] In addition, a deemed distribution will result from a recapitalization only where (1) the transaction is pursuant to a plan to periodically increase a shareholder's proportionate equity interest or (2) the recapitalization is used to eliminate dividend arrearages. [40.1] Finally, the regulations do not seek to implement the "any transaction" language contained in Section 305(c) by identifying transactions that are not listed in the statute.

1.02[2][c] Consequences of Taxable Distributions

***5** A stock distribution that is taxable under Section 305 is treated as a distribution of property to which Section 301 applies. [41] The amount of the distribution is generally the fair market value of the stock or rights received. [42] The earnings and profits of the distributing corporation are reduced by the fair market value of the stock or rights. [43] Similarly, the basis of the distributed stock or rights in the hands of the shareholders is its fair market value, [44] while a new holding period for the stock or rights would begin as of the date following the acquisition. [45]

1.02[3] Transfers Falling Outside of Section 305

Section 305 applies to actual and deemed distributions of stock that are made to shareholders in their capacity as shareholders. Thus, Section 305does not apply to a distribution made to a shareholder in some other capacity (e.g., as an employee). Stock transfers that are made as purchase price adjustments also fall outside of Section 305.

1.02[3][a] Distributions Not Made With Respect to Stock

On its face, Section 305(a) applies only to a stock distribution that is made by the corporation "with respect to its stock." Thus, Section 305 does not apply to distributions of stock (or rights to acquire stock) that are made to a shareholder in a nonshareholder capacity. For instance, stock or options paid to a shareholder in his capacity as an employee of the corporation are subject

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to tax under Section 83, not Section 305.[46] Moreover, Section 305 does not apply to stock transferred as a gift,[47] or to stock transferred to a shareholder in the shareholder's capacity as a creditor of the corporation. Similarly, in Revenue Ruling 82-158,[48] the Internal Revenue Service (the Service) ruled that Section 305 did not apply to preferred stock that was issued in exchange for target stock in a reorganization under Section 368. The distribution fell outside of Section 305, since it was not made with respect to the *acquiring* corporation's stock.[49]

1.02[3][b] Purchase Price Adjustments

The regulations contain an exception from Section 305 where stock is transferred, not as a distribution but as an adjustment to the purchase price paid by the distributing corporation for assets or other property.[50] For example, assume that a corporation acquires the assets of another corporation in exchange for its own stock and, as part of the consideration, agrees to pay additional stock in the future if the target's earnings exceed certain levels. The payment of the additional stock is not a distribution but represents an adjustment to the purchase price, which is not subject to Section 305.[51]

This exception should also apply to prevent a deemed distribution of stock from arising under Section 305(c). That is, if a change in conversion ratio or redemption price of stock is made to reflect future earnings results, the change should be treated as an adjustment to the purchase price of the property so that a deemed distribution would not be created under Section 305(c).[52]

1.02[4] Treatment of Stripped Preferred Stock

***6** The Revenue Reconciliation Act of 1993 added Section 305(e) to the Code to provide special rules for stripped preferred stock.[53] The term "stripped preferred stock" refers to stock if there has been a separation in ownership between the stock and any dividend on the stock that has not become payable.[54] For this purpose, "stock" means stock that (1) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent and (2) has a fixed redemption price.[55]

Under Section 305(e)(1), if any person purchases stripped preferred stock after April 30, 1993, that person must report income on the stock as if it were an original issue discount (OID) bond issued on the purchase date.[56] A "purchase" means any acquisition of stock where the basis of the stock is not determined, in whole or in part, by reference to the transferor's adjusted basis.[57] Conversely, if any person strips the rights to one or more dividends from any stock and disposes of the dividend rights after April 30, 1993, then the stripper is treated as having purchased the underlying stripped preferred stock on that date for a purchase price equal to the adjusted basis in the preferred stock.[58]

The amount of deemed OID on stripped preferred stock is equal to the excess, if any, of (1) the redemption price for the stock over (2) the price at which the person purchased the stock.[59] This amount is includable in income under the economic accrual rules of Section 1272(a) as ordinary income,[60] but not as interest or dividends.[61] Appropriate adjustments to basis must be made for amounts includable in gross income.[62]

Several observations concerning Section 305(e) are worth noting. First, since the deemed OID income is not interest or dividends, the holder of the stripped preferred stock will accrue income without regard to the earnings and profits of the issuer and without the benefit of the dividends received deduction (DRD). Second, Section 305(e) creates deemed OID income only on the underlying stock; it does not apply to the stripped dividends. In contrast, under Section 1286 (dealing with stripped debt

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instruments), OID can arise on both the stripped debt and the stripped coupons. [63] Third, the issuer does not appear to be affected by the stripped treatment at the holder level. Finally, although Congress was aware of many issues arising from stripped stock treatment, it nevertheless chose not to provide any guidance in resolving them. One issue concerns whether the DRD is available to the holder of dividends stripped from the preferred stock. [64] Other open issues include such basic matters as the allocation of basis by the creator of stripped preferred stock, and the proper characterization of a purported sale of stripped dividend rights. [65]

***7** The American Jobs Creation Act of 2004 (the 2004 Jobs Act) [65.1] added new Section 1286(f) to the Code to give the Service authority to issue regulations to address the treatment of stripped bonds and preferred stock that are held by an account or entity. The regulations will apply only if *substantially all* of the assets of the entity or account consist of bonds, preferred stock, or a combination thereof. The regulations are to deal with those situations where Section 1286 or Section 305(e) would not otherwise apply, but according to the statute, the regulations may incorporate rules similar to those of Sections 1286 and 305(e). The regulations will, as a general rule, be applied prospectively, except where retroactive application is needed to prevent abuse.

The legislative history to the 2004 Jobs Act states that a grant of regulatory authority was warranted in order to address tax avoidance transactions into which taxpayers may be entering. Specifically mentioned are transactions involving the buying or selling of bonds and/or preferred stock when the transactions act to generate artificial losses or to defer the recognition of ordinary income and convert the income into capital gains.

According to the legislative history, the regulations could apply to a transaction that involves a person who effectively strips future dividends from money market shares held by a mutual fund and then contributes the shares and future dividends to a custodial account. Acting through the custodial account, another person would then purchase the right to either the stripped shares or the stripped future shares. [65.2]

The legislative history [65.3] makes clear that the regulations will not apply to transactions involving direct or indirect interests in a fund where substantially all of its assets are held in tax-exempt obligations. The Conference Report specifically mentions that a tax-exempt bond partnership that is described in Revenue Procedure 2002-68 [65.4] is an example of the type of fund that will *not* be covered by the future regulations. The basic structure of a tax-exempt bond partnership is as follows: The partnership receives a tax-exempt obligation from a sponsor. The partnership then issues two classes of equity interests: (1) interests that are entitled to a preferred variable return on its capital (variable-rate interests) and (2) interests that are entitled to all the remaining income of the partnership (inverse interest). As a result of the partnership's structure, the partner that holds a variable-rate interest receives a return that is equivalent to the return on a variable-rate tax-exempt bond. [65.5]

Shortly after enactment of Section 1286(f), the Service released Technical Advice Memorandum 200512020, which addressed a scheme that appeared designed to generate losses through income stripping. In this memorandum, the taxpayer had purchased variable rate instruments issued by a foreign issuer and contributed them to a trust vehicle. The vehicle then issued interest-only (IO) interests and principal-only (PO) interests. By then selling the PO interests, the taxpayer claimed it could deduct a loss, because it did not have to allocate its basis in the overall instrument between the PO interests and IO interests. The Service determined that (1) the underlying instruments were equity, not debt (as labelled); (2) the trust should be treated as a partnership, not a grantor trust; (3) the sale of trust interests should be regarded as a proportional sale of the underlying assets under Revenue Ruling 99-5 (Situation One) (rights to both principal and income on the underlying instruments); and (4) the taxpayer had improperly failed to allocate its overall basis between the interests retained and those sold. This memorandum was revoked and reissued as Technical Advice Memorandum 200650017.

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***8** In *Principal Life Insurance Co. v. United States*,[65.6] the taxpayer engaged in two types of transactions: "custodial share receipts" (CSR) transactions and "perpetual securities" (perpetual) transactions. Both transactions involved the creation of an interest in future income payments from a particular security. In the CSR transactions, an unrelated financial institution transferred certain money market fund shares (MMF shares) to a custodian in exchange for two receipts: one representing the rights to the MMF shares' dividends for some period of time (about twenty years), and the other representing the residual rights to the MMF shares after this period. The taxpayer purchased the residual rights. The taxpayer reported no income from the CSR transactions, but the Service determined that the taxpayer should have reported income of about $21 million from 1999 to 2001.

In the perpetual transactions, the taxpayer deposited perpetual, floating rate securities into a trust. In return, the trust issued to the taxpayer two certificates: one representing the rights to the interest paid on the underlying securities for some period of time (about eighteen years), and the other representing the residual rights to the securities. The taxpayer retained the interest rights and sold the residual rights. The taxpayer allocated its basis fully to the residual rights, thereby generating a $291 million loss on their sale. The Service disallowed the loss. In analyzing the taxpayer's basis allocation in the perpetual transactions, the Court of Federal Claims found that Regulation Section 1.61-6 applied to property such as the certificates at issue and that it required a taxpayer to allocate its basis according to the fair market value of the component. The taxpayer's basis allocation (i.e., entirely to the residual interest) was erroneous as a matter of law.

The court further held that the custodial and trust arrangements at issue should be classified as partnerships under Regulation Section 301.7701-4. When analyzing the CSR transactions, because the court treated the arrangements as partnerships, the court ruled that the taxpayer should be allocated a portion of the partnership income that corresponds to its interest in the partnership and thus should include in income a distributive share of each year's money market dividends. The court granted summary judgment in favor of the government.

Footnotes

19 Reg. § 1.307-1(a). However, in the case of a rights distribution, unless the taxpayer elects otherwise, a basis allocation is not required if the fair market value of the rights at the time of the distribution is less than 15 percent of the fair market value of the stock at that time. The basis of the rights would be zero and the basis of the stock would remain unchanged. IRC § 307(b); Reg. § 1.307-2.

20 IRC § 1223(5); Rev. Rul. 76-53, 1976-1 CB 87.

21 See Rev. Rul. 71-350, 1971-2 CB 176; Rev. Rul. 56-653, 1956-2 CB 185; Keeler v. Comm'r, 86 F2d 265 (8th Cir. 1936), cert. denied, 300 US 373 (1937).

22 IRC § 312(d)(1)(B).

23 IRC § 312(f)(2). See, e.g., Priv. Ltr. Ruls. 9814015 (distribution of additional "common preference" shares on outstanding common and common preference shares fell within Section 305(a); distribution was isolated and designed to increase public float of preference shares); 199901024 (pro rata distribution of nonredeemable, nonconvertible participating preferred shares on outstanding common and existing participating preferred shares fell within Section 305(a); the Service presumably treated distribution as a common-on-common distribution).

24 See, e.g., Willens, "New Techniques Avoid Taxability Under Section 305 for Stock Dividends," 69 J. Tax'n 68 (Aug. 1988).

25 These four are analyzed infra ¶ 1.03. In most cases, the shareholders experiencing a decrease in their proportionate interest are compensated by receipt of property in some form, such as cash or debt. If such compensation is not received,

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the shareholders who experience an increase in interest might escape Section 305(b), but nevertheless face taxation under other theories (e.g., as a gift or as wage income).

Importantly, the determination of whether a shareholder's proportionate interest increases is made without regard to the constructive ownership rules of Section 318. Rev. Rul. 78-60, 1978-1 CB 81. But see Priv. Ltr. Rul. 9836004 (shareholder's surrender of stock to issuing company was nonrecognition event; no gift or deemed distributions to other shareholders).

26 IRC § 305(d)(1).

27 IRC § 305(d)(2).

28 House Report, supra note 18, at 113; Senate Report, supra note 18, at 151. Section 305(b)(4) differs from the other exceptions in Section 305(b) because taxation does not turn on the presence of (1) a matching distribution of property (as in Sections 305(b)(2) and 305(b)(5)) or stock (as in Section 305(b)(3)), or (2) an election to receive property (as in Section 305(b)(1)). Thus, stock dividends paid on preferred stock are taxable even if no distribution is made on the corporation's common stock.

29 This approach creates an internal inconsistency within the regulations. That is, in certain places, the regulations treat a Section 305(b)(4) preferred stock dividend as a distribution of "property" rather than stock. See, e.g., Reg. § 1.305-3(e), Ex. 15. This view is consistent with Congress's treatment of preferred stock in Section 305(b)(3) as a substitute for the property requirement of Section 305(b)(2). See House Report, supra note 18, at 113. However, in other instances, the regulations take the position that a Section 305(b)(4) preferred stock dividend is a distribution of stock, not property. See Reg. §§ 1.305-7(a), 1.305-7(c) (indicating that a stock dividend on preferred stock is taxable because it increases the equity position of the recipient shareholder). Distributions on preferred stock are analyzed infra ¶ 1.04.

30 House Report, supra note 18, at 112; Senate Report, supra note 18, at 151. Under this plan, the holder of the preferred stock would generally not be taxed until distributions were received on the common stock or the common stock was disposed of.

31 Importantly, IRC § 305(c) operates to produce a deemed distribution of stock, not property.

32 House Report, supra note 18, at 113; Senate Report, supra note 18, at 151.

33 See infra ¶ 1.04. In effect, Congress believed that dividends paid on preferred stock should be taxed whether they are received in cash or in another form (such as stock, rights to receive stock, or rights to receive an increased amount on redemption). Moreover, dividends on preferred stock were to be taxed to the recipient whether attributable to the current or preceding taxable years. House Report, supra note 18, at 113; Senate Report, supra note 18, at 151.

34 Reg. § 1.305-7(a).

35 See infra ¶ 1.04[2][a].

36 See infra ¶ 1.02[4].

37 Reg. § 1.305-7(a). See supra ¶ 1.02[2][b][i].

38 See supra ¶ 1.02[2][b][i].

39 Reg. § 1.305-7(a).

40 Reg. § 1.305-7(b)(1). As will be discussed infra ¶ 1.05[2], this exception does not apply if the change is made to compensate the convertible holder, in general, for taxable dividends paid to the shareholder of the corporation.

40.1 See, e.g., Priv. Ltr. Ruls. 9819031 (isolated recapitalization to create fixed dividend, common stock did not trigger Section 305(b) or Section 305(c)); 9731021 (isolated recapitalization not made pursuant to a plan to periodically increase earnings).

41 IRC § 305(b)(1). However, Section 311 does not apply to tax the distribution as appreciated property, since the characterization of "property" applies only for Section 301, not Section 311, purposes.

42 See Reg. § 1.305-1(b)(1); Rev. Ruls. 76-53, 1976-1 CB 87, 78-375, 1978-2 CB 130, and 79-42, 1979-1 CB 130. But see Reg. § 1.305-1(b)(2) (exception for a corporation that regularly distributes its earnings, such as a regulated investment company (RIC)). However, if the shareholder receives cash and then buys stock with that cash, the money is taxed under

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the usual dividend rules. Rev. Rul. 77-149, 1977-1 CB 82. In addition, the regulations contain several examples illustrating rules for determining the amount of a deemed distribution arising under Section 305(c)from changes in conversion ratios or periodic redemptions. See Reg. § 1.305-3(e), Exs. 6, 8, 9, and 15.

43 Reg. §§ 1.312-1(d), 1.305-2(b), Ex. 2; Rev. Rul. 76-186, 1976-1 CB 86.

44 IRC § 301(d).

45 Rev. Rul. 76-53, 1976-1 CB 87. Cf. Rev. Rul. 70-598, 1970-2 CB 168.

46 House Report, supra note 18, at 115; Senate Report, supra note 18, at 154; Rev. Rul. 67-402, 1967-2 CB 135. Accord Centel Communications Co. v. Comm'r, 920 F2d 1335 (7th Cir. 1990) (IRC § 305applicable because receipt of warrants was not compensatory). See also Priv. Ltr. Rul. 9814015 (Section 305 did not apply to an adjustment to employee stock options as a result of stock dividend).

47 See IRC § 305(f); House Report, supra note 18, at 115; Senate Report, supra note 18, at 154.

48 1982-2 CB 77.

49 The fact that the target shareholders were given an election to receive cash or stock, thus raising the specter of Section 305(b)(1), did not change the result. However, the Service cautioned that Section 305 could apply to subsequent (and presumably unrelated) changes in the redemption premium or conversion ratio.

50 Reg. § 1.305-1(c). This exception also extends to the transfer of a right to acquire stock that is made to effect a purchase price adjustment.

51 Note that the first transfer of stock in the hypothetical would be exempt from Section 305 under the rationale of Rev. Rul. 82-158, supra Fn 48 (i.e., it is not a transfer with respect to the acquiring corporation's stock). See supra ¶ 1.02[3][a]. Although the second transfer is made with respect to the acquiring corporation's stock, it is exempt from Section 305as a purchase price adjustment.

Form is very important in applying this exception. The same result could have been reached if the preferred stock called for cash dividends to be paid at a rate that increased along with increases in the corporation's earnings. However, under this structure, the cash dividends would be taxable even though they represented contingent consideration for the acquired assets, and even though the same economic effect would be created tax free through an increase in the conversion ratio.

52 Reg. § 1.305-1(c). In Rev. Rul. 73-205, 1973-1 CB 188, the Service considered the treatment of convertible preferred stock that was issued by a corporation in exchange for target stock in a reorganization transaction. The shares were initially convertible into a fixed number of shares of common stock, but because of disagreements over the value of target stock, the ratio could be increased as warranted by the target's earnings. Although the ruling deals with the impact on the reorganization of the right to receive additional stock, it is instructive because the Service did not raise Section 305 issues. That is, but for the purchase price adjustment exception, the increase in conversion ratio would give rise to the deemed distribution of stock under Section 305(c), which would be taxable under Section 305(b)(2) if cash dividends were paid to the common shareholders. The absence of Section 305 correctly reflects the application of the purchase price exception, since change in ratio represents an adjustment in the price to be paid by the acquiring corporation for the target stock.

53 Revenue Reconciliation Act of 1993 (RRA '93) Pub. L. No. 103-66, 103d Cong., 1st Sess., § 13206(c)(1), 107 Stat. 312 (1993).

54 IRC § 305(e)(5)(A).

55 IRC § 305(e)(5)(B).

56 See also RRA '93, supra note 53, at § 13206(c)(1). If the stock is subsequently transferred, deemed OID treatment continues to apply to any person whose basis in the stock is determined by reference to the purchaser's basis in the stock. IRC § 305(e)(1).

57 IRC § 305(e)(6).

58 IRC § 305(e)(3).

59 IRC § 305(e)(1).

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60 IRC § 305(e)(4). See Chapter 4 for a discussion of these rules. See also Chapter 10 for the treatment of stripped bonds.

61 HR Rep. No. 213, 103rd Cong., 1st Sess. 577 (1993).

62 IRC § 305(e)(2).

63 See Chapter 10.

64 HR Rep. No. 213, supra note 61, at 578 (no inference intended as to these issues).

65 Id.

65.1 Pub. L. No. 108-357, 108th Cong., 2d Sess. § 831 (2004).

65.2 HR Conf. Rep. No. 755, 108th Cong., 2d Sess. 606 (2004) (hereinafter Conference Report).

65.3 Conference Report at 606.

65.4 Rev. Proc. 2002-68, 2002-2 CB 753.

65.5 HR Conf. Rep. No. 755, 108th Cong., 2d Sess. (2004). It should be noted, however, that Revenue Procedure 2002-68 was superceded by Revenue Procedure 2003-84, 2003-48 IRB. The House Committee Report (HR Rep. No. 108-548) correctly refers to Revenue Procedure 2003-84 for relevant guidance. Thus, it appears that Revenue Procedure 2003-84 is the appropriate reference, not Revenue Procedure 2002-68.

65.6 Principal Life Ins. Co. v. United States, 113 AFTR2d 2014-2047 (Ct. Fed. Cl. 2014).

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Part I. Equity Investments

Chapter 1. Stock Distributions Under Section 305

1.03 DISTRIBUTIONS HAVING A DISPROPORTIONATE EFFECT

As mentioned earlier, [66] four of the five exceptions in Section 305(b) are designed to tax stock dividends where a shift in the proportionate interest of the shareholders has occurred or may potentially occur (i.e., the interest of some shareholders in the earnings or assets of the corporation has increased, while the interest other shareholders has decreased or been diluted). Because of this common theme, the exceptions overlap one another in many situations.

1.03[1] Distributions of Stock in Lieu of Money

Section 305(b)(1) provides that a distribution of stock is taxable under Section 301 if a shareholder has the option or right to elect to receive money or other property in lieu of stock (or rights to acquire stock) of the distributing corporation. Importantly, if any *one* shareholder has such a right, or can make such an election, then the distribution is taxable to *all* shareholders participating in the distribution, even to those who were not given the option or election. [67] However, if an election can be made only with respect to some of the shares, then only that part of the stock distribution is taxable to the shareholders. [68]

Under Section 305(b)(1), it is the shareholder's ability to make an election, not the exercise of the election, that triggers tax. Thus, the regulations make clear that the stock distribution is taxable regardless of whether the distribution is actually made, in whole or in part, in stock. [69] Moreover, the regulations provide that the distribution will be taxable regardless of whether (1) the election is exercisable before or after the declaration of the distribution [70] or (2) the distribution is to be made in one medium unless the shareholder specifically requests payment in another. [71] Finally, the distribution is taxable no matter if the election is provided in the declaration of the distribution or in the corporate charter, or if it arises from the circumstances of the distribution. [72]

Section 305(b)(1) can apply where a corporation adopts a dividend reinvestment plan [73] or where a regulated investment company (RIC) makes a distribution, since in this latter case the shareholders receiving the distribution usually have the option to take cash or additional stock of the RIC. [74] The Service has ruled that Section 305(b)(1) also applies to a distribution by a corporation to its common shareholders of preferred stock that is immediately redeemable. In the Service's view, the ability to effect an immediate redemption is equivalent to an election to receive stock or cash, thus causing Section 305(b)(1) to apply. [75]

***2** The Service takes the position that Section 305(b)(1) can apply to a stock distribution if the corporation shows a pattern of granting the redemption requests of its shareholders. This view was initially taken with respect to a stock distribution made by a Federal Home Loan Bank (FHLB) to its member banks. The Service charged that the stock distribution was taxable, because the FHLB had an established policy of honoring redemption requests, and because it had not refused any requests made within the past ten years even though it had discretion to do so. [76] However, this position was specifically rejected in *Frontier Savings Association v. Comm'r,* [77] where the Court held that the discretion to honor redemption requests was not relinquished by the FHLB, and therefore the shareholders did not have the equivalent of prohibited election. In light of this defeat, the Service subsequently reversed its position as it applies to the FHLB, but has announced it will continue to take it in other cases where a pattern of granting redemption requests is present. [78]

1.03[2] Disproportionate Distributions Involving Stock and Property

Section 305(b)(2) is the most complex and difficult of the Section 305(b)exceptions to understand and apply. It provides that a stock distribution is taxable under Section 301 if the distribution results in (1) the receipt of money or other property by some shareholders and (2) an increase in the proportionate interests of other shareholders in the earnings or assets of the corporation. [79] The money or property must be received by the shareholder, in his capacity as such, in a distribution subject to Section 301 or certain other specified dividend-type provisions. [80] The required increase in proportionate interest results from the receipt of stock, whether pursuant to an actual distribution or a deemed distribution under Section 305(c).

For purposes of Section 305(b)(2), the usual definition of "property" should apply as it does for any distribution. [81] One exception, however, is that property can include a distribution of stock that is treated as a distribution of property under Section 305. [82]

Importantly, both components of this test must be present. That is, a shareholder's increase in proportionate interest is not taxable under Section 305(b)(2) unless it is accompanied by receipt of property by another shareholder. Conversely, the receipt of property by some shareholders without an increase in proportionate interest of other shareholders is not covered under Section 305(b)(2). Moreover, because the statute requires an increase in *proportionate* interest, such increase must be at the sufferance of another shareholder or group of shareholders, who are generally compensated for the decrease or dilution in their equity interest by the receipt of cash or property. [82.1]

***3** The disproportionate result of Section 305(b)(2) generally arises, and indeed should only be taxable, when the distribution of stock and property are related. However, the regulations do not contain this requirement, and it appears that Section 305(b)(2) can apply even if the receipt of stock and property are unrelated. As will be seen below, the regulations are drafted so broadly that Section 305(b)(2) can apply where (1) the disproportionate result is unintended or otherwise reached without a plan; (2) the property distribution is separated from the stock distribution by up to thirty-six months (and possibly longer); or (3) the disproportionate result is reached through a combination of distributions and other transactions.

1.03[2][a] The Disproportionate Effect in General

One of the most apparent applications of Section 305(b)(2) arises where a corporation has two classes of common stock outstanding, and the corporation makes a distribution of common stock on one class and pays a cash dividend on the other. The stock distribution is taxable under Section 305(b)(2), because some shareholders increase their interest in the earnings and assets of the corporation (by receiving stock), while other shareholders receive property (i.e., cash). [83]

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If the distributing corporation has more than one class of stock outstanding, the regulations provide that each class of stock must be considered separately in determining whether a shareholder has increased his proportionate interest in the earnings assets of a corporation. That is, each shareholder within the class is deemed to have an increased interest if the class of stock as a whole has an increased interest in the corporation. [84] Importantly, in keeping with *Macomber,* [85] the regulations make it clear that the prohibited increase in the corporation's earnings or assets does not arise if the shareholders are merely subdividing the same residual equity interest held before the distribution.

Example 1-2

A corporation has one class of common stock and one class of "vanilla" preferred stock outstanding (i.e., nonconvertible stock that is limited and preferred as to dividends). The corporation makes a distribution of common stock on the outstanding common, and a distribution of cash on the preferred stock. The stock distribution is not taxable because there is no increase in the proportionate interest of the common shareholders. The shareholders' equity position did not change. The common shareholders merely received additional paper to evidence the same interest held before the distribution. [86]

The result in Example 1-2 would change, however, if the common shareholders received preferred stock having a priority equal to the existing preferred stock. In this case, by receiving preferred stock, the common shareholders would enjoy an increased interest in both the earnings (through preferred dividends) and the assets (through liquidation rights) of the corporation at the expense of the existing preferred shareholders. Thus, their proportionate interest would increase, and, since the preferred shareholders received cash, the second component of Section 305(b)(2) would be met. Accordingly, the stock distribution would be taxable. [87]

***4** If applied literally, the breadth of the regulations can be stunning. As a business matter, one would expect that if some shareholders receive stock, the other shareholders would receive property having equivalent value. However, the regulations do not clearly require such equivalency in Section 305(b)(2) cases. For instance, if the stock received by some shareholders has a value in excess of the property received by other shareholders, the regulations appear to tax the entire stock dividend, not just the portion having a value equal to the property distributed. In addition, Section 305(b)(2) should only apply where the shareholders who experience dilution are the ones that receive the property required in Section 305(b)(2). However, this requirement is not found in the regulations.

Example 1-3

A corporation has outstanding two classes of common stock and one class of preferred stock. A common stock distribution is declared on one class of common and cash dividends are paid on the preferred. Nothing is paid on the second class of common stock. Under the regulations, Section 305(b)(2) literally applies to tax the receipt of the common stock dividend, since one group of shareholders increase their proportionate interest, while another group receive property (cash). This result apparently arises even though the cash is not received by the shareholders who experience the dilution in interest (the holders of the second class of common stock). [88]

Finally, the regulations state that property distributions made pursuant to an *isolated* redemption are not subject to Section 305(b)(2), even if they are preceded or followed by an actual stock distribution. [89] In effect, an isolated redemption creates a disproportionate result (since some shareholders receive cash yet others receive stock), but it nevertheless falls outside of Section 305. [90]

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1.03[2][b] Series of Distributions

Both the statute and regulations contemplate that the disproportionate result can arise through either a single distribution or a series of distributions (in which the distribution of stock is only one). [91] For this purpose, a series of distributions encompasses all distributions of stock that result in a shift in proportionate interests of the shareholders in the corporation's earnings or assets. [92] A distribution may be treated as part of a series of distributions even though the disproportionate result is not intended or planned. [93] The key is merely that the disproportionate result is achieved.

Example 1-4

A corporation pays quarterly stock dividends to one class of common shareholders and annual cash dividends to another class of common shareholders, the quarterly stock dividends constitute a series of distributions of stock having the result of the receipt of cash or property by some shareholders and an increase in the proportionate interests of other shareholders. Accordingly, all the quarterly stock dividends are distributions to which Section 301 applies, regardless of whether the stock distributions and the cash distributions are steps in an overall plan or are independent and unrelated. [94]

***5** Importantly, the regulations offer some limit on which distributions can be combined toa produce the disproportionate result. Specifically, the regulations state that if more than thirty-six months elapse from the receipt of cash or property and the distribution (or series of distributions) of stock, the distribution or series of distributions will be presumed not to result in the receipt of cash or property by some shareholders and an increase in the proportionate interest of other shareholders. However, this safe harbor does not apply if the receipt of cash or property and the distribution or series of distributions of stock are made "pursuant to a plan." [95]

1.03[2][c] Disproportion Without Two Distributions

The regulations make it clear that both elements of Section 305(b)(2)—the receipt of cash or property by some shareholders and an increase in the proportionate interest of other shareholders—do not have to occur in the form of an actual distribution. [96] Once again, Section 305(b)(2) applies if the result of a distribution of stock is that some shareholders' proportionate interests increase and other shareholders in fact receive cash or property. The example below, which is taken from the regulations, demonstrates that Section 305(b)(2) can apply if stock is distributed to all shareholders and some of the shareholders later sell the distributed stock for cash.

Example 1-5

A corporation makes a stock distribution to its shareholders. Pursuant to a prearranged plan with the distributing corporation, a related corporation purchases the stock from those shareholders who want cash. Assume that the stock purchase is governed by Section 304 and that the sale proceeds are treated as a distribution under Section 301 by virtue of Section 304. The requirements of Section 305(b)(2)are satisfied because some shareholders receive stock and other shareholders receive property (cash), even though the property is not received by the shareholder in the form of an actual distribution. [97]

This example reinforces the notion that property must be received by the shareholder, in that capacity, in a transaction governed by Section 301 or another specified dividend-type provision. [98] This requirement was met in Example 1-5, because Section

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304 applied to the sale to produce a Section 301 distribution. However, the example is interesting because, due to subsequent amendments to Section 304, the property distribution can now be sourced in a corporation that is different from the one that made the stock distribution. [99] Section 305(b)(2) arguably should not apply if property is received in the capacity as a shareholder of *another* corporation. Moreover, it seems unnecessary to depict a sale pursuant to a prearranged plan. This fact only creates confusion, since the regulations make it clear that Section 305(b)(2)can apply where the disproportionate result is unintended or unplanned. [100]

1.03[2][d] Impact of Rights to Acquire Stock

***6** For Section 305 purposes, the term "stock" includes rights to acquire stock, and the holder of these rights is viewed as a shareholder. [101] The regulations further provide that in determining whether a distribution reaches a disproportionate result, (1) any right to acquire such stock (whether or not exercisable during the taxable year), and (2) any security convertible into stock of the distributing corporation (whether or not convertible during the taxable year) are both treated as outstanding stock. [102] Thus, if some shareholders receive rights to acquire stock and other shareholders receive cash, Section 305(b)(2) will cause the rights distribution to be taxable.

Further, the payment of interest to a holder of a convertible debenture is treated as a distribution of property to a shareholder for purposes of Section 305(b)(2). [103] Accordingly, a distribution of stock to common shareholders is taxable under Section 305(b)(2) if interest is paid on the outstanding convertible securities. [104]

1.03[2][e] Exception for Fractional Shares

Under a special rule, Section 305(b)(2) does not apply if a corporation declares a dividend payable in stock of the corporation and distributes cash in lieu of fractional shares to which shareholders would otherwise be entitled. [105] For this exception to apply, however, the distribution of cash must be "to save the corporation the trouble, expense, and inconvenience of issuing and transferring fractional shares (or scrip representing fractional shares), or issuing full shares representing the sum of fractional shares, and not to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation." [106] The distribution is presumed to meet this test if the total amount of cash distributed in lieu of fractional shares is 5 percent or less of the total fair market value of the stock distributed (determined as of the date of declaration). [107]

1.03[2][f] Application to Deemed Distributions

As described previously, [108] Section 305(c) provides that a change in conversion ratio, a change in redemption price, the presence of a redemption premium, a redemption that is treated as a distribution to which Section 301 applies, or any transaction (including a recapitalization) having a similar effect may be treated as a distribution of stock with respect to any shareholder whose proportionate interest in the earnings or assets of the corporation is increased. [109] The regulations contain a number of illustrations under Section 305(b)(2) where deemed distributions arise under Section 305(c), which are then tested to determine if the distribution is taxable under Section 305(b)(2). These illustrations involve redemption plans and discount preferred stock, described below, along with certain other transactions. [110]

1.03[2][f][i] Redemption having dividend consequences.

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***7** A redemption that is treated as a dividend has the same effect as if a cash dividend were paid to the redeeming shareholders, while a stock dividend was paid to the other shareholders. Section 305(c) provides that this redemption can result in a deemed distribution of stock to any shareholder whose proportionate interest is increased by the transaction. [111] Section 305(b)(2)can thus be triggered. According to the legislative history, however, this aspect of Section 305(c) was intended to capture "periodic redemption plans," under which stock is redeemed from some shareholders over time in small increments, and as a result, the interest of other shareholders is gradually increased. [112]

Example 1-6

A corporation adopts a plan to periodically redeem a portion of stock held by nine of its ten shareholders. Under the plan, the corporation each year will redeem a small portion (up to 5 percent) of the outstanding shares held by the nine shareholders. During the year, the nine shareholders receive cash in redemptions that are taxed as a dividend. Under Section 305(c), the remaining shareholder is treated as receiving a distribution of stock to reflect the resulting increase in proportionate interest. Accordingly, Section 305(b)(2) applies to tax the remaining shareholder on the deemed distribution of stock. [113]

The regulations contain several examples indicating that a deemed distribution will not arise under Section 305(c) if the redemptions are made pursuant to established business practices. In one example, a publicly held company established a practice of purchasing shares of stock held by small shareholders. The purpose of the buy-back plan was to acquire shares (1) for subsequent issuance to employees under stock investment plans; (2) for subsequent issuance to holders of convertible instruments or options; or (3) for use in acquisitions. The example concludes that the buy-back will not trigger a deemed distribution of stock under Section 305(c), provided the corporation does not have a plan to create a disproportionate result among its shareholders. [114]

Another example depicts a manufacturing corporation that sells products through independent dealers. In order to assist its new dealers, the manufacturer has an established investment plan under which it will provide 75 percent of the initial capital needed to form a dealership corporation, with the individual dealer providing the balance. The manufacturer's stock in the corporation is systematically eliminated through subsequent redemptions, and, as a result the individual dealer becomes the sole shareholder in the corporation. The example concludes that because the arrangement is akin to a security interest, the redemptions will not result in deemed distribution under Section 305(c) to nonredeeming shareholders. [115]

Finally, consistent with the legislative history, the regulations indicate that Section 305(c) does not apply in the case of an *isolated* redemption of stock. Thus, if one shareholder is redeemed in an isolated transaction, Section 305(c) does not apply to create a deemed distribution of stock to the shareholders who increase their interest as a result of the redemption. [116] A similar result was reached in Revenue Ruling 77-19, [117] where the Service ruled that a "squeeze out" merger that was employed to redeem minority shareholders in a publicly traded corporation did not trigger Section 305(b)(2). [118]

1.03[2][f][ii] Deemed distributions on preferred stock.

***8** As indicated above, the property component of the Section 305(b)(2) test may be satisfied by a separate distribution of stock on preferred stock that is treated as "property" under Section 305(b)(4). This principle can be gleaned from an example in the regulations, which is set forth below.

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Example 1-7

A corporation having a single class of common stock outstanding issues convertible preferred stock. The preferred is convertible into the same class of common stock that is outstanding. Assume that the redemption price of the preferred is excessive, and as a result, a deemed distribution to the preferred shareholders results under Section 305(c). Under Section 305(b)(4), the deemed distribution of stock is treated as a distribution of property to which Section 301 applies. Finally, assume that the corporation declares and pays a common stock dividend to the holders of the common stock but the conversion ratio on the preferred stock is not adjusted to reflect the common stock dividend.

The common shareholders increase their proportionate interest in the corporation (through receipt of common stock without adjustment to the conversion ratio on the preferred). In addition, the preferred shareholders are treated as receiving property (by virtue of the deemed distribution of preferred stock, which is taxable as a distribution of property under Sections 301 and 305(b)(4)). As a result, Section 305(b)(2) applies to the common stock dividend. [119]

This example demonstrates the treatment of preferred stock as property, but it also provides useful insight into the operation of Section 305(b)(2). That is, if the conversion ratio were fully adjusted to reflect the *common* stock dividend (i.e., prevent dilution), then the common shareholders' proportionate interest would not increase and the common stock dividend would not be taxable. [120] Similarly, the distribution of common stock would not be taxable to the common shareholders under Section 305(b)(2) if common stock was actually distributed to the holders of the convertible preferred stock. [121] Finally, if the preferred stock were not convertible, Section 305(b)(2) would not apply to the receipt of the common stock because the common shareholders would not have increased their proportionate interest as a result of the stock distribution. [122] In each of these variations, however, Section 305(b)(4) would still apply to the deemed distributions on the preferred stock.

1.03[2][f][iii] Recapitalizations.

The regulations provide that a recapitalization will be deemed to result in a distribution to which Section 305(c) applies if it is pursuant to a plan to periodically increase a shareholder's proportionate interest in the earnings or assets of the corporation. [123] A class of transactions recently has developed (popularly known as “leveraged recapitalizations”) that feature a recapitalization under Section 368(a)(1)(E) where some shareholders of a corporation exchange their old stock in the corporation for new stock and a large amount of cash. As part of the transaction, other shareholders of the corporation (typically management) exchange their old stock solely for new stock of the corporation. The cash is usually provided through massive borrowings by the corporation.

***9** The transaction raises the possibility that Section 305(b)(2) could apply to shareholders receiving only stock in the transaction, since the other shareholders receive cash and thus create a disproportionate result. However, in Revenue Ruling 75-93, [124] the Service ruled that a recapitalization that caused a disproportionate result did not trigger a deemed distribution under Section 305(c) because of the isolated nature of the transaction. The Service found support for this conclusion in the treatment of an isolated redemption under Section 305(b)(2). [125] Thus, Section 305(b)(2) should not apply if the recapitalization can be shown to be an isolated transaction. [126] Interestingly, the same economic effect can be achieved by simply redeeming some, but not all, of the shareholders for cash, or by distributing cash to some shareholders and stock to others in an actual distribution. While a leveraged redemption would generally be an isolated event, and thus should not trigger Section 305(b)(2), [127] an actual distribution of cash and stock would be taxable. Nevertheless, the Service has indicated that form will be respected. [128]

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1.03[3] Distribution of Common and Preferred Stock

Under Section 305(b)(3), a distribution of both common stock and preferred stock to existing *common* shareholders may be taxable. In addition, actual and deemed distributions can both trigger Section 305(b)(3).

1.03[3][a] In General

Specifically, Section 305(b)(3) states that a distribution is taxable if, as a result of the distribution, some common shareholders receive common stock while other common shareholders receive preferred stock. If Section 305(b)(3) is triggered, then receipt of both the common and preferred stock is taxable. [129]

Example 1-8

A corporation has two classes of common stock outstanding. The corporation makes a distribution of common stock with respect to one class and a distribution of preferred stock with respect to the other class of common stock. Both distributions are taxable under Section 305(b)(3). [130]

Section 305(b)(3) is best viewed as a variation of Section 305(b)(2). That is, the legislative history indicates that the preferred stock described in Section 305(b)(3) in effect takes the place of "property" in a Section 305(b)(2) transaction. [131] In essence, a Section 305(b)(3) distribution creates a disproportionate effect and is thus taxable because some shareholders experience an increase in their proportionate interest in the earnings and assets of the corporation (through additional common stock) while other shareholders receive a property-like interest (the preferred stock). [132]

The regulations contain an example illustrating the point that Section 305(b)(3) can be triggered where convertible preferred stock is distributed to shareholders.

Example 1-9

***10** A corporation with one class of common stock outstanding distributes to its shareholders a new issue of convertible preferred stock. The preferred stock must be converted within only six months of issuance and has a conversion price near the market value of the common stock. Taking into account the dividend rate, redemption provisions, the marketability of the convertible stock, and the conversion price, it is reasonable to anticipate that within a relatively short period some shareholders will exercise their conversion rights and some will not.

Since the distribution can reasonably be expected to result in the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders, the distribution is a distribution of property to which Section 301 applies. Consequently, the distribution of the preferred is within Section 305(b)(3) and results in taxable income. [133]

Importantly, as with Section 305(b)(2), the common and preferred stock do not have to be distributed at the same time. The Section 305(b)(3) result can be reached through a series of distributions, so long as both are generally made within thirty-six months of each other. [134]

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1.03[3][b] Deemed Distributions of Stock

As described above, [135] Section 305(c) provides that a change in conversion ratio, a change in redemption price, the presence of a redemption premium, a redemption that is treated as a distribution to which Section 301 applies, or any transaction (including a recapitalization) having a similar effect may be treated as a distribution of stock with respect to any shareholder whose proportionate interest in the earnings or assets of the corporation is increased. A deemed distribution that arises from one of these events can be taxable if it has the effect described in Section 305(b)(3). [136]

For instance, the regulations provide that under Section 305(c), a recapitalization, whether or not isolated, will result in a deemed distribution of stock if it is pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation. The regulations contain an example of a frequently encountered recapitalization where older shareholders exchange common stock for preferred stock in preparation of retirement. The example concludes that Section 305(b)(3) does not apply.

Example 1-10

A corporation has one class of common stock outstanding. In preparation for the retirement of it senior shareholder, the corporation undergoes a recapitalization in which the senior shareholder exchanges his common stock for preferred stock and the other shareholders exchange their old stock for new common stock in the corporation. The recapitalization is a single and isolated transaction. Accordingly, none of the exchanges are within Section 305. [137]

***11** Importantly, form often plays a crucial role in determining whether Section 305 applies, and this is no different under Section 305(b)(3). This fact was demonstrated in Revenue Ruling 86-25, [138] where the Service ruled that a recapitalization similar to the one described in Example 1-10 was not subject to Section 305(b)(3), even though the transaction had the same economic effect as an outright distribution of preferred stock and new common stock on the old common stock. The Service noted that an actual distribution would have been taxable under Section 305(b)(3), but nevertheless ruled that Section 305(b)(3) did not apply because the parties chose to consummate the transaction as a recapitalization. The Service respected the form of the transaction. [138.1]

1.03[4] Distributions of Convertible Preferred Stock

Section 305(b)(5) provides that a distribution of convertible preferred stock is taxable unless it is established, to the Service's satisfaction, that the distribution will not result in a disproportionate distribution within the meaning of Section 305(b)(2). The regulations indicate that a distribution is likely to have a disproportionate effect when two conditions are met. The first is that the conversion right must be exercised within a relatively short time after the distribution. The second is that, taking into account such factors as dividend rate, the redemption provisions, marketability of the convertible stock, and the conversion price, some, but not all, of the shareholders are likely to exercise the conversion right. [139]

The regulations state that a disproportionate effect is not likely where conversion is exercisable over many years and the dividend rate is consistent with market conditions. In these cases, there is no “basis for predicting at what time and to what extent the stock will be converted.” [140] These conditions “ordinarily [are] sufficient to establish that a disproportionate distribution will not result since it is impossible to predict the extent to which the...stock will be converted.” [141] The regulations contain the following example where the taxpayer could not satisfy the burden imposed by Section 305(b)(5).

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Example 1-11

Assume that a corporation issues redeemable convertible preferred stock that must be converted within four months. Also assume, however, that an insurance company through a prearrangement has agreed to purchase preferred stock that is not converted. Given this, it is anticipated that some shareholders will convert while others will sell their stock to the insurance company for cash (i.e., the disproportionate result of Section 305(b)(2) is expected). Accordingly, Section 305(b)(5)applies. [142]

Finally, as described previously, [143] Section 305(c) provides that a change in conversion ratio, a change in redemption price, the presence of a redemption premium, a redemption treated as a distribution to which Section 301 applies, or any transaction (including a recapitalization) having a similar effect may be treated as a distribution of stock with respect to any shareholder whose proportionate interest in the earnings or assets of the corporation is increased. A deemed distribution that arises from one of these events can be taxable if it has the effect described in Section 305(b)(5). [144]

Footnotes

66 See supra ¶ 1.02[2][a].

67 Reg. § 1.305-2(a)(5).

68 See Reg. § 1.305-2(b), Ex. 1.

69 Reg. § 1.305-2(a)(1). Section 305(b)(1) overlaps with Section 305(b)(2) in that the latter also applies if some, but not all, of the shareholders elect to receive property. However, Section 305(b)(1) is broader than Section 305(b)(2), because the election itself triggers tax even if no shareholder makes the election or if all shareholders make the same election. In either of these latter cases, the disproportionate effect described in Section 305(b)(2) is not present, yet the distribution is taxable.

70 Reg. § 1.305-2(a)(2).

71 Reg. § 1.305-2(a)(3).

72 Reg. § 1.305-2(a)(4).

73 Rev. Rul. 76-53, 1976-1 CB 87. In Rev. Rul. 80-154, 1980-1 CB 68, the Service ruled that Section 305(b)(1) does not apply where the board resolution declaring the dividend requires the shareholder to invest the dividend in additional stock of the corporation. This type of arrangement was not the equivalent of an election, since the shareholders did not have the option to take cash or property in lieu of stock.

74 Reg. § 1.305-2(b), Ex. 2. Cf. Rev. Rul. 65-220, 1965-1 CB 317.

75 Rev. Rul. 76-258, 1976-2 CB 95 (stock was redeemable at any time after distribution at the request of the holder). This rationale does not apply if the redemption is subject to Section 303. See Rev. Rul. 87-132, 1987-2 CB 82.

76 Rev. Rul. 83-68, 1983-1 CB 75.

77 Frontier Sav. Ass'n v. Comm'r, 87 TC 665 (1986), aff'd sub nom. Colonial Sav. Ass'n v. Comm'r, 854 F2d 1001 (7th Cir. 1988), cert. denied, 109 S. Ct. 1556 (1989), acq. 1990-1 CB 1.

78 Rev. Rul. 90-98, 1990-2 CB 56.

79 This dual result is sometimes referred to in this chapter as the "disproportionate result" or "disproportionate effect."

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80 Specifically, the property must be received in transaction governed by Sections 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b), and 857(b). Reg. § 1.305-3(b)(3). Thus, a redemption that gives rise to sale or exchange treatment under Section 302(a) would not count as a distribution of property for Section 305(b)(2) purposes.

81 See IRC § 317(a) (for purposes of Sections 301-317, "property" does not include stock of the distributing corporation). Unless the context indicates otherwise, a reference herein to property includes a reference to money as well as property.

82 See Reg. § 1.305-3(e), Ex. 15.

82.1 For an illustration of these principles, see Priv. Ltr. Rul. 9836004 (shareholder's surrender of stock as a capital contribution was not treated as a taxable distribution to the other shareholders; no distribution of property made to surrendering shareholders that would trigger Section 305(b)).

83 Reg. § 1.305-3(e), Ex. 1. The example follows the Citizens Utility situation, discussed at supra ¶ 1.01[3]. The example notes that the result would not change even as to those shareholders who own both classes of stock in the same proportion.

84 Reg. § 1.305-3(b)(6).

85 See supra ¶ 1.01[1].

86 Reg. § 1.305-3(e), Ex. 2.

87 Reg. § 1.305-3(e), Ex. 3. This example points out that the distribution would not have been taxable if the preferred stock distributed to the common shareholders was subordinated to the outstanding preferred. This example also does not raise any question that the preferred stock is properly treated as "preferred stock" for Section 305 purposes. The result might be different if the purported preferred stock is treated as common stock in applying Section 305. See, e.g., Priv. Ltr. Rul. 9814015 (distribution of additional "common preference" shares on outstanding common and common preference shares fell within Section 305(a); distribution was isolated and designed to increase public float of preference shares; the Service presumably treated distribution as a common-on-common distribution); Priv. Ltr. Rul. 199901024 (pro rata distribution of nonredeemable, nonconvertible participating preferred shares on outstanding common and existing participating preferred shares fell within Section 305(a); the Service presumably treated the distribution as a common-on-common distribution).

88 In Rev. Rul. 75-93, 1975-1 CB 101, the Service would have applied the regulations in this manner to tax a recapitalization under Section 305(b)(2) but for the fact that the transaction was isolated and not within Section 305(c). However, it seems that if property is not received by the shareholders who experience dilution, the better result is to ignore the cash dividends for Section 305(b)(2) purposes and to tax the increase in interest outside of Section 305 (e.g., as a gift or as wages).

89 See Reg. §§ 1.305-3(b)(3), 1.305-3(e), Ex. 10(isolated redemption not part of plan to periodically redeem shareholders). For an example of an isolated redemption followed by a deemed distribution of stock, see Reg. § 1.305-3(e), Ex. 11, discussed infra ¶ 1.03[2][f][i]. This assumes that the redemption is taxable as a dividend under Section 301, since capital gain redemptions generally do not trigger Section 305(b)(2). See supra ¶ 1.03[2].

90 Here the importance of form can be critical, since the same economic effect can be achieved through an actual distribution of stock and cash, without a redemption. However, an actual distribution would clearly be captured by Section 305(b)(2), whereas an isolated redemption would not. See also infra ¶ 1.03[2][f][iii] (dealing with isolated recapitalizations). But see Priv. Ltr. Rul. 9814015 (isolated distribution of a common preference shares on outstanding common and common preference shares was not taxable; the Service, however, appears to have treated distribution as a common-on-common distribution).

91 IRC § 305(b)(2); Reg. § 1.305-3(b)(1).

92 Reg. § 1.305-3(b)(1).

93 Reg. § 1.305-3(b)(2).

94 Id.

95 For example, if, pursuant to a plan, a corporation pays cash dividends to some shareholders on January 1, 1991, and increases the proportionate interests of other shareholders on March 1, 1994, the increases in proportionate interests are distributions to which Section 301 applies. See Reg. § 1.305-3(b)(4).

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96 Reg. § 1.305-3(b)(3).

97 Id. Query whether Section 305(b)(2) would apply if all shareholders sold their stock, since the disproportionate result would not arise among the pre-existing shareholders. If Section 305(b)(2) did not apply, Section 306 would apply on the sale of the preferred stock.

98 See supra ¶ 1.03[2].

99 See IRC §§ 304(a), 304(b)(2)(A). Prior to 1984, IRC § 304(b)(2)(A) indicated that the property was sourced with the issuing corporation. See Pub. L. No. 98-369, 98th Cong., 2d Sess. § 712(1)(*l*) (1984) (amending IRC § 304).

100 See supra ¶ 1.03[2][b].

101 IRC § 305(d).

102 Reg. § 1.305-3(b)(5).

103 Reg. § 1.305-3(b)(3).

104 The impact of rights to acquire stock and convertible securities is discussed in greater detail infra ¶ 1.05.

105 Similarly, Section 305(b)(2) is not activated if a conversion of convertible stock or securities occurs and the corporation distributes cash in lieu of fractional shares.

106 Reg. § 1.305-3(c)(1). If this exception applies, the transaction is treated as though the fractional shares were distributed as part of the stock distribution and were then redeemed by the corporation. Reg. § 1.305-3(c)(2). The treatment of the cash received by a shareholder is determined under Section 302. Conversely, if the exception does not apply, then either Section 305(b)(1) or Section 305(b)(2) could tax receipt of the fractional stock.

107 Reg. § 1.305-3(c)(1).

108 See supra ¶ 1.02[2][b].

109 Reg. § 1.305-7(a).

110 Deemed distributions can also arise where convertible securities or rights to acquire stock are involved. See supra ¶ 1.05.

111 Reg. § 1.305-7(a).

112 House Report, supra note 18, at 114; Senate Report, supra note 18, at 153. The determination of whether a shareholder's proportionate interest increases is made without regard to the constructive ownership rules of IRC § 318. Rev. Rul. 78-60, 1978-1 CB 81.

113 Reg. § 1.305-3(e), Ex. 8 (also illustrating the methodology for determining the number and value of shares deemed distributed). See also Reg. § 1.305-3(e), Ex. 9 (same).

114 Reg. § 1.305-3(e), Ex. 13. Thus, without a deemed distribution, Section 305(b)(2) will not apply. However, this example is questionable, because the redemptions illustrated would generally qualify as capital gain redemptions. As a result, the Section 305(b)(2)property requirement would not be met. See supra ¶ 1.03[2].

115 Reg. § 1.305-3(e), Ex. 14. The Service has indicated that it will apply this "security device" exception in analogous cases where redeemable stock is used to finance the acquisition of a business and other forms of financing are not available. See Rev. Rul. 78-115, 1978-1 CB 85.

116 Reg. § 1.305-3(e), Ex. 10. This result follows Reg. § 1.305-3(b)(3), which states that an isolated redemption will not cause IRC § 305(b)(2) to apply. Cf. Reg. § 1.305-3(e), Ex. 11(isolated redemption preceded by actual stock distributions not subject to Section 305).

117 Rev. Rul. 77-19, 1977-1 CB 83.

118 The redemption was viewed as an isolated redemption given its magnitude (80 percent of the shareholders were redeemed). The fact that the corporation had made prior redemptions from retired and deceased shareholders did not change the conclusion that Section 305(c) was inapplicable.

119 Reg. § 1.305.3(e), Ex. 15.

120 See Reg. § 1.305-3(e), Ex. 15. See infra ¶ 1.05 for a discussion of convertible securities.

121 However, with respect to the preferred shareholders, the actual receipt of common stock would be taxable under Section 305(b)(4). See Rev. Rul. 83-42, 1983-1 CB 76. See also infra ¶ 1.04.

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122 See Reg. § 1.305-3(e), Ex. 2, discussed supra ¶ 1.03[2][a]. The treatment of preferred stock dividends as property is consistent with the legislative history underlying Section 305(b)(3) and with Congress's view that stock dividends are a substitute for cash dividends. However, the regulations also suggest that preferred stock dividends are taxable because they cause an increase in proportionate interest of the recipient shareholder, a view that treats the preferred stock as "stock," not "property." See, e.g., Reg. § 1.305-7(a).

123 Reg. § 1.305-7(c). A deemed distribution can arise whether or not the recapitalization is an isolated transaction.

124 Rev. Rul. 75-93, 1975-1 CB 101.

125 See also Rev. Rul. 86-25, 1986-1 CB 203.

126 See Rosen & Conway, "Leveraged Restructurings: Treatment of the Cash," 66 Taxes 987 (1988). See also Priv. Ltr. Rul. 9814015 (Section 305 did not apply to an adjustment to employee stock options as a result of stock dividend); Priv. Ltr. Rul. 9728005 (single recapitalization involving exchange of outstanding voting and nonvoting common stock for new nonvoting preferred stock to concentrate voting power within management did not trigger Section 305(b) or Section 305(c)).

127 See supra ¶ 1.03[2][f][i].

128 See Rev. Rul. 86-25, 1986-1 CB 203. But see Priv. Ltr. Rul. 9814015 (isolated distribution of a common preference shares on outstanding common and common preference shares not taxable; the Service, however, appears to have treated the distribution as a common-on-common distribution).

129 Reg. § 1.305-4(a).

130 Reg. § 1.305-4(b), Ex. 1.

131 House Report, supra note 18, at 113. Congress apparently wanted to foreclose the possibility that Section 305(b)(2) could be avoided by distributing preferred stock to some shareholders in lieu of actual property. Section 305(b)(3) taxes the distribution of common and preferred stock up front, without waiting for Section 306 to apply upon the disposition of the preferred stock.

132 In effect, preferred stock has a chameleon-like quality. Under Section 305(b)(3), it is viewed as a property substitute. However, under the regulations, it is also viewed at times as stock, the receipt of which is taxable because it increases the shareholder's proportionate interest in the earnings or assets of the corporation. See, e.g., Reg. §§ 1.305-7(a), 1.305-7(c).

133 Reg. § 1.305-4(b), Ex. 2. This example appears to be an attempt by the Treasury to fill a hole in the statutory scheme. That is, one would expect distributions of convertible preferred to fall within Section 305(b)(5). However, a distribution of convertible preferred stock is taxable under Section 305(b)(5) only if it has a disproportionate effect described in Section 305(b)(2) (i.e., receipt of stock and property). Example 1-9 results in a disproportionate effect described in Section 305(b)(3), not Section 305(b)(2). Thus, to render the distribution taxable, the example looks to the result of the distribution and treats it as a distribution of common and preferred stock on the common stock.

134 See Reg. § 1.305-4(a) (last sentence). See also supra ¶ 1.03[2] [b].

135 See supra ¶ 1.02[2][b].

136 Reg. § 1.305-7(a).

137 Cf. Reg. § 1.305-3(e), Ex. 12.

138 1986-1 CB 203.

138.1 But see Priv. Ltr. Rul. 9814015 (isolated distribution of a common preference shares on outstanding common and common preference shares not taxable; the Service, however, appears to have treated the distribution as a common-on-common distribution).

139 Reg. § 1.305-6(a)(2).

140 Id. Section 305(b)(5) would not apply if conversion by substantially all shareholders was expected or if no one was expected to convert the stock. In these cases, the disproportionate result of Section 305(b)(2) is not present. See House Report, supra note 18, at 114; Senate Report, supra note 18, at 153.

141 Reg. § 1.305-6(b), Ex. 1 (stock convertible over twenty-year period).

142 Reg. § 1.305-6(b), Ex. 2 (following a similar example from the legislative history). The example also notes that a sale by some shareholders does in fact occur. This seems to suggest that hindsight will be used in determining whether Section

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305(b)(5) applies, even though both the statute (and regulations themselves) focus on what can be *expected* from the distribution. The example also illustrates a difference between Sections 305(b)(2) and 305(b)(5), in that the property apparently does not have to be received as a dividend in a Section 305(b)(5)situation, while it does for Section 305(b)(2) to apply.

143 See supra ¶ 1.02[2][b].

144 Reg. § 1.305-7(a).

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Part I. Equity Investments

Chapter 1. Stock Distributions Under Section 305

1.04 DISTRIBUTIONS ON PREFERRED STOCK

Under Section 305(b)(4), any distribution of stock that is made on preferred stock is generally treated as a taxable distribution. The operation of Section 305(b)(4) in the context of both actual and deemed stock distributions is described below.

1.04[1] Statutory Framework

The application of Section 305(b)(4) to so-called payment-in-kind (PIK) preferred stock and cumulative preferred stock is described below. The definition of "preferred stock," which is extremely important in applying Section 305(b)(4), is also covered below.

1.04[1][a] In General

Section 305(b)(4) provides, with one exception, that any distribution by a corporation of its stock made with respect to its preferred stock is treated as a taxable distribution of property to which Section 301applies. [145] Section 305(b)(4) reflects Congress's determination that stock distributions with respect to preferred stock should in all cases be taxable, regardless of whether the distribution is disproportionate. The view apparently is that because preferred stock characteristically pays specified cash dividends, stock dividends must represent a substitute for those dividends and therefore should be taxed. [146]

1.04[1][a][i] Payment-in-kind stock.

Since Congress amended Section 305 in 1969, the use of PIK preferred stock has increased. A PIK preferred stock contemplates that dividends may be paid in the form of additional preferred stock of the issuer. This stock is often used in acquiring a target business, because the PIK feature gives the acquiring corporation the ability to preserve and manage its cash flow. However, the receipt by the shareholder of the stock dividend would be treated under Section 305(b)(4) as a distribution of stock on preferred stock.

1.04[1][a][ii] Cumulative preferred stock.

Section 305(b)(4) can also be triggered where cumulative preferred stock is issued. In Revenue Ruling 84-141, [147] the holder of a cumulative preferred stock had the right to receive common stock dividends if cash dividends were not paid for two consecutive quarters. The Service ruled that upon passage of two successive quarters, the shareholders were in constructive receipt of a common stock dividend. [148] Accordingly, under Section 305(b)(4), the distribution was taxable.

1.04[1][b] Exception for Conversion Ratio Increases

Section 305(b)(4) contains a single exception for increases in the conversion ratio of convertible preferred stock "made solely to take account of a stock dividend or stock split with respect to the stock into which the preferred is convertible." The regulations expand the exception to include stock dividends, stock splits, and "similar events." For this purpose, a "similar event" includes a below-market sale of stock pursuant to a rights offering, which would otherwise result in the dilution of the conversion right. [149]

***2** This exception is notable for two reasons. First, it involves a deemed rather than an actual distribution of stock. Accordingly, one would expect to find this exception in Section 305(c) rather than in Section 305(b)(4). Secondly, it is not clear why a deemed distribution should be exempt from Section 305(b)(4), but not an actual distribution of stock made for the same reasons. Nevertheless, differences in form lead to dramatically different tax results. For instance, in Revenue Ruling 83-42, [150] a corporation distributed common stock as a dividend to its common shareholders. In order to prevent dilution to the holders of its convertible preferred, the corporation made an actual distribution of common stock to the preferred shareholders. The Service ruled that the distribution of common stock to the preferred shareholders was taxable under Section 305(b)(4) as a distribution on preferred stock. The fact that the identical economic effect could have been achieved tax free through an adjustment to the conversion ratio did not change the result. [151]

1.04[1][c] Definition of "Preferred Stock"

Since Section 305(b)(4) applies only to distributions on preferred stock, the definition of this term is critical. Under the regulations, the term "preferred stock" for purposes of Section 305(b)(4) generally refers to stock that, in relation to other classes of stock outstanding, enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities). In effect, the distinguishing feature of preferred stock for the purposes of this test is not its superior ranking with respect to other classes of stock, but rather that the stock is limited and nonparticipating. Stock that participates in corporate growth to any significant extent is not preferred stock. [152]

However, participation rights that lack substance are ignored in determining whether Section 305(b)(4) applies. [153] According to the regulations, the test is whether it is "reasonable to anticipate...that there is little or no likelihood of such stock actually participating in current and anticipated earnings *and* upon liquidation beyond its preferred interest." [154] This test is applied based on the facts and circumstances existing at the time the distribution is made or is deemed to have been made. Among the factors to be considered are (1) the prior and anticipated earnings per share; (2) the cash dividends per share; (3) the book value per share; (4) the extent of preference and of participation of each class (both absolutely and relative to each other); and (5) any other facts that indicate whether or not the stock has a real and meaningful probability of actually participating in the earnings and growth of the corporation. [155] The regulations illustrate these concepts through two examples, the first of which is below.

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Example 1-12

***3** A corporation has one class of common stock and one class of preferred stock outstanding. The preferred stock participates with the common stock in both current dividends and liquidating distributions. However, the book value of the corporation's assets is equal only to the total amount required to be paid to the preferred upon liquidation (based on the number of shares outstanding and the liquidation price of the preferred). In addition, the corporation has no accumulated earnings and profits, and its past and projected earnings are insufficient to support a participating dividend. Accordingly, it is not reasonable to anticipate that the preferred stock would participate in the current and anticipated earnings and growth of the corporation beyond its preferred interest. As a result, the preferred stock is treated as "preferred stock" for Section 305(b)(4)purposes. [156]

The result changes in the next example, because of differences in the participation rights and in the book value of the corporation's assets and its projected earnings.

Example 1-13

Assume in Example 1-12 that the preferred stock participates with the common stock in current dividends after a much lower dividend is paid on the common, and that the book value of the corporation's assets greatly exceeds the liquidation preference of the preferred. Further assume that the corporation has significant accumulated earnings, that its past and projected earnings are sufficient to support a participating dividend on the preferred, and that participating dividends were in fact paid in the recent past. On these facts, it is reasonable to anticipate that both the preferred stock and the common stock will participate in the current and anticipated earnings and growth of the corporation beyond their preferred interest. Thus, neither class is preferred stock and Section 305(b)(4) does not apply. [157]

As a final point, the regulations state that conversion rights are ignored in determining whether stock qualifies as preferred stock. [158] Thus, the fact that the shareholders participate in growth through the conversion right is ignored. Further, the regulations provide that preferred stock does not include convertible debentures. [159]

1.04[2] Deemed Distributions of Stock Under Section 305(c)

As described above, [160] Section 305(c) provides that a change in conversion ratio, a change in redemption price, the presence of a redemption premium, a redemption that is treated as a distribution to which Section 301 applies, or any transaction (including a recapitalization) having a similar effect may be treated as a distribution of stock with respect to any shareholder whose proportionate interest in the earnings or assets of the corporation is increased. [161] In the case of preferred stock, a deemed distribution under Section 305(c) most often arises because of a redemption premium inherent in the stock (i.e., discount preferred stock is involved). The issues raised by discount preferred stock are discussed below, along with the treatment of recapitalizations and changes in the redemption price of preferred stock. [162]

1.04[2][a] Treatment of Redemption Premiums

***4** As indicated earlier, [163] a redemption premium arises on discount preferred stock to the extent that the stock can be redeemed at a price that is higher than its issue price. [164] The premium is generally amortized under Section 305(c) as a series of deemed stock distributions on the underlying preferred stock. These deemed distributions are taxable under Section 305(b)(4).

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Congress amended Section 305(c) in the Revenue Reconciliation Act of 1990 to change the treatment of discount preferred stock. [165] Under the new rules, OID principles are used to determine whether a premium is present and if so, the manner in which it is amortized. Congress intended these new rules to apply to stock where the issuer is required to redeem the stock at a specified time (mandatorily redeemable preferred stock) or where the holder has the option to require the issuer to redeem the stock (puttable preferred stock). [166] Under amended Section 305(c), special rules apply to stock that is callable by the issuer.

1.04[2][a][i] Pre–RRA '90 regime.

Prior to the change made by RRA '90, a holder of preferred stock was not required to amortize into income a redemption premium if the premium was found to be "reasonable." A redemption premium was "reasonable" to the extent it was (1) in the nature of a penalty for a premature redemption and (2) not in excess of the amount the corporation would be required to pay for the right to make a premature redemption under market conditions existing at the time of issuance. [167] Under a special safeharbor provision, a redemption premium was considered to be reasonable if it was not in excess of 10 percent of the stock's issue price, where the stock could not be redeemed for five years from the date of issue. [168] For this purpose, the issue price of preferred stock was, and presumably still is, the price paid for the stock if issued for cash, [169] or its fair market value at the time of issuance, if issued in a distribution or a tax-free reorganization. [170]

Example 1-14

Corporation *X* issues preferred stock for $100 per share. The stock is redeemable in five years or any time thereafter for $110. The redemption price at no time exceeds 10 percent of the issue price. Under prior law, the difference between the redemption price and the issue price was considered to be reasonable and therefore was not deemed to be a distribution on preferred stock under Section 305(c) to which Sections 305(b)(4) and 301 apply. [171]

In determining whether a premium was reasonable, the Service generally looked to the amount that was negotiated or agreed to by the parties, not the actual amount that is determined at issuance. Thus, in Revenue Ruling 75-468, [172] shareholders of a target corporation agreed to exchange target stock for acquiring corporation stock. The new stock could be called by the issuer in five years at a redemption premium of 5 percent, based on values at the time the agreement was reached. When the merger was consummated, the premium had grown to 16 percent due to a decline in the value of the target stock. Nonetheless, the premium was found to be reasonable, since the excess over 10 percent was not bargained for nor intended to exceed a typical call premium. However, in Revenue Ruling 81-190, [173] the Service discussed a similar situation where stock values had changed after negotiations had closed. The Service followed Revenue Ruling 75-468 but indicated that it did so because business constraints precluded a renegotiation of the stock terms in the instant case.

***5** In testing the reasonableness of a premium, the Service, in the past, also analyzed whether a redemption was likely to occur pursuant to the right. For instance, in Revenue Ruling 75-179, [174] the Service analyzed a convertible, redeemable preferred stock and found that a redemption premium of 83 percent was reasonable. The Service reasoned that the issuer could call the stock only if the fair market value of the stock was in excess of the call price. Since the redemption premium encouraged conversions, redemptions theoretically should never occur. Thus, despite its size, the premium was reasonable.

Under the pre-990 Act rules, if a premium was found to be unreasonable to any extent, the holder had to accrue the unreasonable portion (and only that portion) of the premium ratably over the period that the stock could not be called for redemption. [175] In the

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case of publicly traded preferred stock, this ratable reporting led to results that resembled dividend stripping. That is, although the deemed distributions of stock occurred ratably for tax purposes, for financial purposes the discount was generally deemed to accrue based on OID principles. Thus, holders of discount preferred stock could obtain unintended benefits, as illustrated below.

Example 1-15

A corporation acquires newly issued preferred stock for $1,000. The stock does not pay current dividends and is subject to mandatory redemption after five years for $1,500. Under prior law, a deemed stock distribution of $100 would arise each year. Thus, the holder would treat $100 as a dividend (assuming sufficient earnings and profits) and would increase its basis in the stock by a corresponding amount. Assume that the corporation properly claims a DRD under Section 243 and deducts 70 percent of the dividends. Thus, after the first year, the shareholder would have paid tax on $30 of dividend income and would have an adjusted basis in the stock of $1,100.

From an economic perspective, the yield on the preferred stock is approximately 8.28 percent (assuming semi-annual compounding). Thus, after one year, the value of its share would be approximately $1,083. Accordingly, a sale of the share at this value would produce a capital loss of $17 ($1,100 (basis) − $1,083). The capital loss could offset unrelated capital gain, thereby converting the gain into dividend income taxable at favorable rates (because of the DRD). [176]

Under the pre-1990 Act rules, current accrual of a redemption premium could be avoided if the preferred stock was immediately redeemable. The Service had ruled prior to RRA '90 that current accrual of the redemption premium was not required if the preferred stock was callable throughout its term, even if the call right was never exercised. The rationale was that no period existed over which to amortize the premium. [177]

1.04[2][a][ii] Changes made by RRA '90.

***6** Congress recognized that preferred stock issued with a redemption premium resembles debt issued at a discount. [178] Congress also believed that if income from a financial instrument is payable on a deferred basis, that income should generally be accrued and reported, not on a straight-line basis, but on an economic basis over the period during which payment is deferred. [179] Thus, RRA '90 amended Section 305(c) to provide that a redemption premium must be taken into account using the economic accrual rules of Section 1272(a). [180] In effect, the premium is amortized as a stream of stock distributions using a constant yield to maturity. Since these economic accrual rules rely on present value and compounding principles, the amount of the deemed distributions increase as the maturity date nears. [181]

In addition, amended Section 305(c) looks to the OID de minimis rules to determine whether preferred stock has a redemption premium. [182] Under these rules, a redemption premium must be amortized into income if the redemption price at maturity exceeds the issue price by an amount that equals or exceeds the product of (1) one quarter of 1 percent of the redemption price and (2) the number of complete years to maturity. [183] In contrast to prior law, if this de minimis threshold is exceeded, the *entire* amount of a redemption premium must be amortized into the holder's income, not just the portion deemed to be unreasonable. [184] A redemption premium that does not exceed the de minimis threshold is ignored until redemption.

The economic accrual rule and the OID de minimis rule apply to mandatorily redeemable preferred stock and puttable preferred stock. [185] Further, these rules apply to mandatorily redeemable and puttable preferred stock that is issued on or after October 10, 1990. [186]

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Congress, however, gave special consideration to the treatment of stock that is callable at the option of the issuer (callable preferred stock). First, Congress chose not to extend the OID de minimis rule to callable preferred stock (unless such stock is also subject to a mandatory redemption or is puttable). Instead, Congress indicated that the pre-1990 Act rules would continue to apply to determine whether the premium on callable preferred stock is unreasonable. [187] The pre-1990 Act standard is higher than the OID de minimis amount, and Congress believed it was appropriate to allow such a higher threshold in determining whether deemed distributions should arise on callable preferred stock, since the decision to redeem the stock rests with the issuer and not the holder of the stock. [188]

Second, if the premium is determined to be unreasonable under the pre-1990 Act rules, then the economic accrual rule applies to amortize the entire call premium, not just the unreasonable portion. However, the legislative history states that the call premium must be amortized over the period during which the preferred stock cannot be called for redemption. [189] This statement appears to preserve the pre-1990 Act treatment of immediately callable preferred stock (i.e., no current accrual of discount). [190] Thus, taken together, the economic accrual rule generally applies for callable stock issued on or after October 10, 1990, regardless of when regulations implementing new Section 305(c) are issued. However, the pre-1990 Act rules pertaining to immediately callable stock and the determination of whether the premium on that stock is reasonable both remain in effect until regulations under amended Section 305(c) are finalized. [191]

1.04[2][a][iii] Treatment under final regulations.

***7** On June 22, 1994, proposed regulations under amended Section 305(c) were released. [192] After a relatively short period, the regulations were finalized in December 1995 (the final regulations). [193] These regulations are consistent with the statute in providing that the economic accrual rules apply to amortize the premium on preferred stock, whether the stock is redeemable, puttable, or callable. However, despite the above noted legislative history that a higher de minimis threshold should apply to callable preferred stock, the final regulations—like the proposed version—extend the OID de minimis rule to callable preferred stock as well. [194]

The final regulations add a provision under which preferred stock will constitute "redeemable" stock in certain cases where it may be acquired by a person other than the issuer, such as stock that is puttable to a third person. However, this rule does not apply unless the stock would be subject to Section 305(c) if the third party were the actual issuer, and one of the following two tests is met: (1) The acquisition of the stock by the third person would be treated as a redemption for federal income tax purposes (under Section 304 or otherwise), or (2) the third person and the issuer are members of the same affiliated group, [195] and a principal purpose of the arrangement for the third person to acquire the stock is to avoid the application of Section 305. [196]

The final regulations clarify that preferred stock is considered subject to a holder put even if the put is not currently exercisable. [197] The regulations also provide guidance in the case of mandatorily redeemable or puttable preferred stock where the redemption and put rights are subject to contingencies. [198] Specifically, current amortization of a redemption premium is not required if the issuer's redemption obligation or the holder's put right is subject to a contingency that is (1) beyond the legal or practical control of either the holder or the holders as a group [199] and (2) based on all of the facts and circumstances as of the issue date, renders remote the likelihood of redemption. [200] For example, assume that preferred stock is issued and that the terms of the stock provide that it must be redeemed upon an initial public offering (IPO) of the issuer. Under the regulations, the likelihood of an IPO transaction must be evaluated to determine if current accrual is necessary (i.e., because the stock is mandatorily redeemable stock for Section 305(c)purposes). [201]

With regard to callable preferred stock, the regulations provide that the premium on callable preferred stock must be amortized only if redemption pursuant to that right is "more likely than not" to occur. [202] Unlike pre-1990 Act law, no exception is provided merely because the stock is immediately callable. The regulations, however, contain two exceptions that provide relief from current amortization.

***8** Under the first exception, the holder is not subject to current accrual if the premium is "solely in the nature of a penalty for premature redemption." [203] To satisfy this test, the premium must be paid as a result of changes in economic or market conditions over which neither the issuer nor the holder has legal or practical control. [204] This test would be met, for example, if the premium was paid because of changes in prevailing dividend rates or in the value of the common stock into which the stock is convertible. [205] This first exception can apply even if it is more likely than not that a redemption under the call right will occur.

The second exception contains an important safe harbor under which a redemption right does not meet the "more likely than not" test. The safe harbor applies if (1) the issuer and the holder are not related; [206] (2) there are no plans, arrangements or agreements (hereinafter plans) that effectively require or are intended to compel the issuer to redeem the stock; [207] and (3) exercise of the right to redeem would not reduce the yield of the stock as determined under principles similar to the Section 1272(a) principles. [208] Importantly, the failure to satisfy the safe harbor does not affect the determination of whether the right to redeem is more likely than not to occur. [209] Conversely, satisfaction of the safe harbor will not prevent constructive distributions if the stock is also mandatorily redeemable or subject to a holder put. [210]

Example 1-16

Assume that a corporation has only common stock outstanding and that it acquires the stock of a target corporation in exchange for 100 shares of its 4 percent preferred stock. The issue price of the preferred stock is $40 per share, and each share of the preferred is convertible at the shareholder's election into three shares of the acquiror's common stock. At the time the preferred stock is issued, the common stock of the acquiring corporation has a value of $10 per share. In addition, the preferred stock can be redeemed solely at the option of the acquiring corporation at any time beginning three years from the date of issuance for $100 per share. The shareholders of the target are unrelated to the acquiror both before and after acquisition. There are no other plans that would effectively require (or are intended to compel) the acquiror to call the preferred stock.

The preferred stock is within the safe harbor, because the acquiring corporation and the former shareholders of the target are unrelated, there are no plans that effectively require (or are intended to compel) the acquiror to redeem the stock, and calling the stock for $100 per share would not reduce the yield of the preferred stock. Therefore, the $60 call premium is not treated as a constructive distribution to the preferred shareholders. [211]

***9** The regulations contain an example of a preferred stock that permits the holder to appoint a majority of the corporation's directors if the issuing corporation fails to exercise its option to call by a predetermined date. The example states that it is reasonably anticipated that the issuer will have available funds sufficient to exercise the right to redeem, and concludes that Sections 305(c) and 305(b)(4) apply because, by virtue of the change of control provision and the absence of any contrary facts, it is "more likely than not" that the corporation will exercise its option to call the preferred stock. The safe harbor did not apply because the ability to appoint a majority of board directors constituted an arrangement that effectively required the corporation to redeem the preferred stock. [212]

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Where the preferred stock can be redeemed at more than one time, the time and price of the redemption that is most likely to occur must be determined. [213] This determination is made based on all of the facts and circumstances as of the issue date. Any deemed distribution of stock is based on that time and price of redemption. [214] If redemption does not occur at that time as expected, then the "more likely than not" analysis is reapplied to determine whether and when the option is next expected to be exercised. The amount of any additional premium payable on any later redemption date, to the extent not previously treated as distributed, is treated as a deemed distribution of stock over the period from the missed call or put date to that later date. [215]

Under the regulations, the issuer's determination as to whether there is a constructive distribution is generally binding on all holders of the stock. [216] In order to escape this binding treatment, a holder that disagrees with the issuer's determination must explicitly disclose this fact on its tax return. [217]

The final regulations generally apply prospectively to stock issued after December 19, 1995. [218] However, the regulations make clear that the statutory amendments to Section 305(c) apply to stock issued on or after October 10, 1990, subject to the limitations contained in the legislative history. [219] Thus, the economic accrual rules apply to the entire premium on callable preferred stock issued on or after October 10, 1990, but only if the premium is unreasonable as determined under the pre-1990 Act rules. Further, immediately callable stock issued before December 20, 1995, remains subject to the pre-1990 Act rules (i.e., no current accrual of discount generally).

1.04[2][a][iv] Unresolved issues.

RRA '90's incorporation of OID principles into Section 305(c) raises a number of unresolved issues. For example, a key determinant in applying Section 305(b)(4) is the issue price of the preferred stock; however, it is now uncertain whether the OID rules will apply to make this determination in a Section 305 context. [220] The Treasury has not indicated how broadly it intends to apply new Section 305(c). [221]

***10** Further, as noted in the legislative history, Congress did not intend to limit the Treasury's authority regarding the proper treatment of redemption premiums nor what constitutes a premium. The legislative history goes on to state that a disguised premium may be found (and taxed on a current basis) where a preferred stock pays cumulative dividends and there is no intention to pay dividends currently. [222] In addressing this issue, the government conceivably could apply the OID rules for determining stated redemption price at maturity. That is, these principles could be employed to determine the redemption price of the preferred stock, which could then be used in determining if a disguised premium is present. Other OID provisions that could conceivably apply are the acquisition premium rules of Section 1272(a)(7) (i.e., to reduce deemed dividends if the basis of stock exceeds its issue price) and the rules pertaining to contingent interest. However, different policies animate the OID provisions and extreme caution should be taken before extending these rules to Section 305. [223]

The legislative history to RRA '90 makes it clear that the Service has authority to determine what constitutes a redemption premium (or a disguised redemption premium). In particular, the legislative history provides that, if at the time of issuance of cumulative preferred stock, there is no intention for dividends to be paid currently, the Service may issue regulations to treat such dividends as a disguised redemption premium. However, the legislative history expressly states that any such regulations are to apply prospectively. [223.1] The preamble to the 1994 proposed regulations invited comments as to the appropriate treatment of cumulative dividends. When the regulations were finalized in 1995, the preamble to the final regulations stated that "because of the complexity of this issue the final regulations do not provide rules for those dividends. The IRS and Treasury will continue to consider the issue, as well as other issues involving the implementation of the amendments to Section 305(c) made by the

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Revenue Reconciliation Act of 1990." Based on the foregoing, many practitioners believe, and the better view is, that Section 305(c) is not self-executing, and that cumulative dividends are not subject to Section 305(c) in the absence of regulations. [223.2]

However, in Chief Counsel Advice 201152016, a corporation held preferred shares with a fixed dividend rate, compounded daily. Shareholders were entitled to cash dividends on two specified closing dates but afterward dividends were accrued and payable at redemption. The redemption premium was calculated by increasing the issue price of the stock by the accrued dividends. The corporation argued that the preferred stock was not Section 1504(a)(4) stock because the payment at redemption violated Section 1504(a)(4)(C). In rejecting this position, the Service took the surprising view that because the fixed dividend rate compounded daily, Section 305(b)(4) and Section 305(c), working together, required the corporation to report the dividends as income in the year they accrued. This position is contrary to the legislative history and is inconsistent with the Service's prior statements made in the preamble to the 1995 final Section 305(c) regulations. As noted earlier, the better view is that Section 305(c) does not apply to cumulative dividends in the absence of regulations.

1.04[2][b] Recapitalization Transactions

***11** A corporation can employ a recapitalization to achieve results that resemble those of a distribution of stock on preferred stock. [224] However, the regulations under Section 305(c) indicate that a deemed distribution results from a recapitalization only where (1) the transaction is pursuant to a plan to periodically increase a shareholder's proportionate equity interest or (2) the recapitalization is used to eliminate dividend arrearages. The resulting deemed distribution would be taxed under Section 305(b)(4).

1.04[2][b][i] Periodic increases in interest.

The regulations provide that an increase in a preferred shareholder's proportionate interest occurs in any case where the greater of the fair market value or the liquidation preference of the new stock received exceeds the issue price of the old preferred stock surrendered in the exchange. [225] However, as indicated above, a plan for periodic increases of this nature must be present in order for Section 305(c) to apply. Thus, an isolated recapitalization of new common for old preferred should not trigger Section 305(c), even if the fair market value of the common stock exceeds the issue price of the old preferred. [226]

Example 1-17

Corporation *A,* a publicly held company whose stock is traded on a securities exchange (or in the over-the-counter market) has two classes of stock outstanding, common and preferred. The preferred stock is nonvoting and nonconvertible, limited and preferred as to dividends, and has a fixed liquidation preference. There are no dividend arrearages. At the time of issue of the preferred stock, there was no plan or prearrangement by which it was to be exchanged for common stock. In order to retire the preferred stock, Corporation *A* recapitalizes and the preferred stock is exchanged for common stock. The transaction is not deemed to be a distribution under Section 305(c). [227]

1.04[2][c][ii] Eliminate dividend arrearages.

If a recapitalization is used to eliminate dividend arrearages, the amount of the deemed distribution under Section 305(c) is the lesser of (1) the excess fair market value or the liquidation preference, whichever is greater, of the stock received in the

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exchange over the issue price of the preferred stock surrendered or (2) the amount of the dividends in arrears. [228] The resulting deemed distribution is subject to tax under Section 305(b)(4).

Example 1-18

A corporation has cumulative preferred stock and common stock outstanding. The corporation is four years in arrears on dividends to the preferred shareholders. The issue price of the preferred stock is $100 per share. Pursuant to a recapitalization, the preferred shareholders exchange their old preferred stock, including the right to dividend arrearages, on the basis of one old preferred share for 1.20 shares of new preferred shares. Immediately following the recapitalization, the new preferred shares are traded at $100 per share. The new preferred shares are entitled to a liquidation preference of $100.

***12** The preferred shareholders have increased their proportionate interest in the earnings and assets of the corporation, since the fair market value of 1.20 shares of new preferred stock ($120) exceeds the issue price of the old preferred stock ($100). Accordingly, the preferred shareholders are deemed under Section 305(c) to receive a distribution in the amount of $20 on each share of old preferred stock and the distribution is one to which Section 305(b)(4) applies. [229]

1.04[2][c] Change in Redemption Price

Section 305(c) also provides that a change in redemption price can give rise to a deemed distribution of stock. Although Congress offered no insight as to its intended scope, this provision appears to function as a backstop for Section 305(b)(4). That is, a corporation can either issue preferred stock that pays dividends in additional stock or it can issue preferred stock having a redemption price that gradually escalates over time. The same economic result is reached in both cases. While Section 305(b)(4) applies to the first case, it only applies to the second case because Section 305(c)creates a deemed distribution of stock because of the increase in redemption price. [230]

1.04[2][d] Other Transactions

The regulations contain two examples where Section 305(c) distributions do not occur. One involves a modification to a conversion right made necessary by a recapitalization. [231] The other involves preferred stock received in a reorganization, where the new stock received has the same market value as the old stock and no greater call price or liquidation preference. [232]

Footnotes

145 See also Reg. § 1.305-5(a).

146 Staff of the Joint Comm. on Tax'n, Summary of HR 13270, The Tax Reform Act of 1969, 91st Cong., 1st Sess. 63 (1969). The regulations, however, appear to suggest a second policy rationale for Section 305(b)(4)—that preferred stock dividends increase the recipient's interest in the earnings or assets of the corporation and are therefore taxable. See, e.g., Reg. §§ 1.305-7(a), 1.305-7(c). This accords with the regulatory definition of "preferred stock" contained in Reg. § 1.305-5, which stresses the limited nature of a preferred stock interest (i.e., since preferred stock is limited, any stock distribution will increase the shareholder's proportionate equity interest in the corporation). However, this view in effect

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treats preferred stock as "stock," a characterization that conflicts with its treatment as "property" in other instances in the regulations. See, e.g., Reg. § 1.305-3(e), Ex. 15.

147 Rev. Rul. 84-141, 1984-2 CB 80.

148 See Reg. § 1.301-1(b).

149 Reg. § 1.305-5(a). However, the regulations state that a "similar event" does not include an adjustment in the conversion ratio of convertible preferred stock that was made solely to take into account the distribution by a closed-end RIC of a capital gain dividend with respect to the stock into which the preferred stock is convertible.

150 Rev. Rul. 83-42, 1983-1 CB 76.

151 In describing this exception, Reg. § 1.305-5(a)refers simply to distributions, thus suggesting that an actual distribution could fall within the exception. However, in Rev. Rul. 83-42, the Service stated that the regulation only encompasses deemed distributions.

152 Reg. § 1.305-5(a). See, e.g., Priv. Ltr. Rul. 9814015 (distribution of additional "common preference" shares on outstanding common and common preference shares fell within Section 305(a); distribution was isolated and designed to increase public float of preference shares; the Service presumably chose not to treat preference shares as preferred stock); Priv. Ltr. Rul. 199901024 (pro rata distribution of nonredeemable, nonconvertible participating preferred shares on outstanding common and existing participating preferred shares fell within Section 305(a); the Service presumably treated distribution as a common-on-common distribution).

153 Id.

154 Id. (emphasis added).

155 Id.

156 Therefore, the distribution of preferred shares to the preferred shareholders was a distribution to which Sections 305(b)(4) and 301 apply. Reg. § 1.305-5(d), Ex. 8. Query whether this stock would be viewed as participating if the corporation's earnings were insufficient to pay the full dividend on the preferred and the value of its assets was below the liquidation preference at the time of the distribution. In this case, one could argue that the stock is participating (or conversely, that it is not limited), since any growth in earnings and assets will inure first to the benefit of the preferred shareholder. Cf. Priv. Ltr. Rul. 8940006 (indicating that such stock might be viewed as participating for Section 382purposes).

157 Reg. § 1.305-5(d), Ex. 9.

158 Reg. § 1.305-5(b)(1).

159 Id.

160 See supra ¶ 1.02[2][b].

161 Reg. § 1.305-7(a).

162 Deemed distributions can also arise due to changes in conversion ratios and similar events. These transactions are discussed infra ¶ 1.05.

163 See supra ¶ 1.02[2][b].

164 For the determination of issue price, see infra ¶ 1.04[2][a][i].

165 See Revenue Reconciliation Act of 1990 (RRA '90 or 1990 Act), Pub. L. No. 508, 101st Cong., 2d Sess. § 11322(a), 104 Stat. 1388.

166 The legislative history refers to preferred stock issued with a premium that "will be redeemed or, if it can reasonably be assumed that the stock will be redeemed, on a fixed date." HR Rep. No. 881, 101st Cong., 2d Sess. 347 (1990).

167 Former Reg. § 1.305-5(b)(2) (1994). The regulations indicated that this amount can be established by comparing call premium rates on comparable stock that pays comparable dividends.

168 Former Reg. § 1.305-5(b)(2) (1994).

169 Former Reg. § 1.305-5(d) (1994), Exs. 4, 5 (price paid on issuance).

170 See Former Reg. § 1.305-5(d), Ex. 7 (1994) (preferred stock issued as stock dividend); Rev. Rul. 83-119, 1983-2 CB 57 (preferred stock issued in a recapitalization); Rev. Rul. 81-190, 1981-2 CB 84 (preferred stock issued in a B reorganization); Rev. Rul. 76-107, 1976-1 CB 89 (Preferred stock issued in exchange for the common stock of another

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company). Accord Rev. Rul. 90-87, 1990-2 CB 32 (redemption price and liquidation preference govern calculation of COD where preferred stock is issued in exchange for debt, but these amounts do not determine the issue price of the preferred stock for Section 305 purposes).

However, in other instances, the Service has indicated that the issue price of preferred stock is the fair market value of the stock or property to be received in exchange for the preferred stock, not the value of the preferred stock itself. See Rev. Rul. 75-468, 1975-2 CB 115 (preferred stock issued in a tax-free merger); Rev. Rul. 75-179, 1975-1 CB 103 (preferred stock issued in a tax-free merger). See also Reg. § 1.1502-20(e)(3), Ex. 1; Rev. Proc. 81-60, 1981-2 CB 680 (checklist for Section 368(a)(1)(E)recapitalization defining "issue price of preferred stock" as fair market value of the stock to be surrendered by the shareholder). The Service presumably views the value of the new preferred stock as equivalent to the value of the property received by the issuer in exchange for the stock, but its position should be clarified.

171 Former Reg. § 1305-5(d) (1994), Ex. 4.

172 Rev. Rul. 75-468, 1975-2 CB 115.

173 Rev. Rul. 81-190, 1981-2 CB 84.

174 Rev. Rul. 75-179, 1975-2 CB 103.

175 Former Reg. § 1.305-5(b)(1) (1994); Former Reg. § 1.305-5(d), Ex. 5 (1994); Rev. Rul. 76-107, supra note 170. Stated differently, the holder was treated as receiving a series of equal stock distributions that were taxable under Section 305(b)(4) as distributions on the underlying preferred stock. In Rev. Rul. 83-119, 1983-2 CB 57, the Service ruled that the unreasonable portion of a redemption premium on stock that could not be redeemed until the holder's death had to be amortized over the holder's life expectancy.

176 The treatment of dividend stripping is discussed in detail in Chapter 2.

177 GCM 35824 (May 20, 1974); Priv. Ltr. Rul. 8338001.

178 HR Rep. No. 881, supra note 166, at 347.

179 Id.

180 IRC § 305(c)(3).

181 See Chapter 4 for a discussion of these OID principles. Treasury was directed to issue regulations to provide special rules that are consistent with the OID rules in order to determine the maturity date and price of puttable preferred stock. Thus, the holder is presumed to exercise a put option if the action increases the yield on the preferred stock. See Reg. § 1.1272-1(c)(5); HR Rep. No. 881, supra note 166, at 348 (referencing a similar provision in the prior proposed OID regulations). The regulations under amended Section 305(c) generally follow this approach. See infra ¶ 1.04[2] [a][iii].

182 IRC § 305(c)(1).

183 See IRC § 1273(a)(3).

184 HR Rep. No. 881, supra note 166, at 347. In the words of the statute, no portion of the premium is considered to be "reasonable."

185 See IRC §§ 305(c)(1), 305(c)(3). Congress believed that the economic accrual rules should generally apply to preferred stock issued with a redemption premium if the stock will be redeemed or if it can reasonably be assumed that the stock will be redeemed on a fixed date. HR Rep. No. 881, supra note 166, at 347.

186 See IRC §§ 305(c)(1), 305(c)(3). See also RRA '90, supra note 165, at § 11322(b). These rules are effective regardless of when regulations are issued. HR Rep. No. 881, supra note 166, at 348–349. In addition, Section 305(c)(2) provides that these new rules apply even if the stock is also callable at the issuer's option. Moreover, Treasury has authority to treat stock that in form is merely callable as being subject to a mandatory redemption or a put if the existence of other arrangements effectively require the issuer to redeem the stock. HR Rep. No. 881, supra note 166, at 348.

187 See supra ¶ 1.04[2][a][i]. The legislative history states that stock that is subject to mandatory redemption (or is puttable) and is also callable would be tested under both the OID de minimis rule and the pre-RRA '90 rules of the regulations in effect without regard to this provision (i.e., the mandatory redemption or put premium would be tested under the OID

de minimis rule and the call premium would be tested under the pre-RRA '90). If one or more of the premiums is less than the amount considered de minimis under these tests, then accrual is not required for such premium or premiums. Regulations are to provide rules for appropriate accrual if more than one premium exceeds the applicable de minimis rule. HR Rep. No. 881, supra note 166, at 348.

188 HR Rep. No. 881, supra note 166, at 347.

189 Id.

190 See supra ¶ 1.04[2][a][i].

191 The legislative history states that Congress did not intend to limit Treasury's authority to determine what constitutes a redemption premium. HR Rep. No. 881, supra note 166, at 348. Congress also did not intend to limit the Treasury's authority in promulgating regulations relating to the accrual of redemption premiums on callable preferred stock, although the regulations are to apply prospectively. Id. As described below, final regulations were issued in December 1995.

192 CO-8-91, 59 Fed. Reg. 32,160 (1994). See Willens, "Redeemable Preferred Stock Prop. Regs. Reduce Danger of Constructive Dividends," 81 J. Tax'n 214 (Oct. 1994); Sheppard, "How to Beat Constructive Dividend Treatment, Maybe," 65 Tax Notes 402 (Oct. 24, 1994).

193 TD 8643.

194 Reg. § 1.305-5(b)(1). See supra ¶ 1.04[2][a][ii]. The preamble to the proposed regulations acknowledged the higher de minimis threshold outlined in the legislative history. Nevertheless, the government apparently felt that the OID de minimis rule was appropriate because the regulations limit constructive distribution treatment on callable preferred stock to circumstances where the stock is economically similar to mandatorily redeemable stock. According to the preamble, the call premium in these cases cannot fairly be said to be "in the nature of a penalty for premature redemption," which falls outside of the intended scope of the exception in the pre-RRA '90 regulations. Given this, there is no reason to retain the pre-RRA '90 de minimis standard for callable stock.

195 Reg. § 1.305-5(b)(1). For this purpose, "affiliated group" is defined in IRC § 1504(a), except that IRC § 1504(b) does not apply. Id.

196 Id. The preamble to the final regulations warns that an agreement with a third person to acquire the stock may create a conversion transaction within the meaning of IRC § 1258. See generally Chapter 19.

197 Reg. § 1.305-5(b)(2).

198 Id.

199 The contingency also must be beyond control of any party who is related to the holder or holders within the meaning of IRC § 267(b) or IRC § 707(b). Reg. § 1.305-5(b)(2).

200 For this purpose, a contingency does not include the possibility of default, insolvency, or similar circumstances, or that a redemption may be precluded by applicable law that requires that the issuer have a particular level of capital, surplus, or similar items. A contingency also does not include an issuer's option to require earlier redemption of the stock. Id.

201 Preamble to the final regulations.

202 Reg. § 1.305-5(b)(3)(i).

203 Id.

204 Id.

205 Preamble to the proposed regulations. The theory is that a premium that reflects increases in the value of the holder's stock arising from postissuance events is not equivalent to a distribution and should therefore be taxed at redemption. In contrast, if on the date ofissuance it is more likely than not that an issuer will exercise its call option based on the economic terms of the stock, then the holder's anticipated increase in the earnings and assets of the issuer through the call premium is equivalent to a periodic return on the stock. Such a call has the effect of a mandatory redemption provision, so that the premium should be taxed over time as a distribution. Id.

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206 Reg. § 1.305-5(b)(3)(ii)(A). For this purpose, related-party status arises if the parties are described in Section 267(b)(including Section 267(f)(1)) or Section 707(b), as modified to incorporate a 20 percent ownership threshold as opposed to the normal 50 percent threshold. Reg. § 1.305-5(b)(3)(ii)(A). According to the preamble to the final regulations, the threshold was lowered from 50 percent to 20 percent as a safeguard against abuse. The lower threshold relates only to eligibility for the safe harbor and not to the application of the general "more likely than not" test. Thus, if a holder's ownership interest exceeds this threshold, it is appropriate to determine whether redemption is more likely than not based on all of the facts and circumstances.

In addition, the final regulations reject comments that Section 1504(a)(4) stock should be ignored in determining related-party status. According to the preamble, when a holder's ownership interest in an issuer exceeds the threshold, even if all that the holder owns pure preferred stock, it is appropriate to determine whether redemption is more likely than not to occur based on all of the facts and circumstances.

207 Reg. § 1.305-5(b)(3)(ii)(B). These plans must relate to the issuer's call right, not a later mandatory redemption date. Moreover, separate mandatory redemption rights are ignored in applying the test to call rights. Finally, the safe harbor is not intended to be available where an issuer and a holder have an underlying "understanding" regarding redemption. See preamble to the final regulations.

208 Reg. § 1.305-5(b)(3)(ii)(C). The exercise of a call at a premium would generally increase the yield on the preferred stock. Therefore, the availability of the safe harbor in most cases turns on whether the parties are related and whether the prohibited plan is present.

209 Reg. § 1.305-5(b)(3)(iii).

210 See Reg. § 1.305-5(d), Ex. 8.

211 Reg. § 1.305-5(d), Ex. 4.

212 Reg. § 1.305-5(d), Ex. 5. The "more likely than not" threshold may not be met if the issuer expects it will not have sufficient funds to make a redemption at the call date. See Reg. § 1.305-5(d), Ex. 8.

213 Reg. § 1.305-5(b)(4).

214 Id.

215 Id. See Reg. § 1.305-5(d), Ex. 7.

216 The issuer must provide the relevant information to the holder in a reasonable manner. For example, the issuer may identify a representative of the issuer who will make available the information required to comply with this provision. Reg. § 1.305-5(b)(5).

217 Unless the Service provides otherwise, the disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the date the holder acquired the stock. Id.

218 See id.

219 See supra ¶ 1.04[2][a][ii].

220 Issue price for OID purposes is determined under Sections 1273 and 1274, which are discussed in detail in Chapters 4 and 5 . Under Section 1274, the issue price of nonpublicly traded debt bearing adequate stated interest is generally the stated principal amount of the debt. If a parallel rule applied to nonpublicly traded stock, the issuer would generally test for premium by comparing the face amount of the preferred with its redemption amount, assuming the dividend rate was adequate. However, the task of determining whether a dividend rate on preferred stock is adequate may prove too daunting, given the different risk profiles of the various issuers and different tax consequences to the holders (e.g., availability of Section 243).

221 Commentators have suggested that the issue price of the new preferred be determined by reference to the fair market value of the stock. However, they also suggest that the redemption premium should not be created in a tax-free recapitalization where old preferred stock is exchanged for new preferred stock. New York State Bar Association Tax Section Corporations Committee, "Report on Regulations to Be Issued Implementing the Changes to Section 305(c) Made by the Revenue Reconciliation Act of 1990," 52 Tax Notes 1199, 1206 (Sept. 2, 1991); Glen A. Kohl, "Selected Issues Involving Preferred Stock, Equity Recapitalizations, and Section 305," in Tax Strategies for Corporate

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Acquisitions, Dispositions, Financings, Joint Ventures, Reorganizations and Restructurings 1992, 333 PLI Tax Law and Estate Planning Series 769, 824 (1992) ("Tax Strategies"); James L. Dahlberg and Robert J. Mason, "Section 305(c) After the Budget Reconciliation Act of 1990," in Tax Strategies supra at 859, 871–872 (1992). The commentators support their position by notingthat a rule that creates a redemption premium in a tax-free reorganization could result in imputed income under Section 305(c) even where the taxpayer's basis in the stock is equal to or greater than the redemption price of the stock. While this approach has merit, it also resembles the treatment of debt under former Section 1275(a)(4), which was repealed in RRA '90. See RRA '90, supra note 165, at § 11325(a)(2).

222 HR Rep. No. 881, supra note 166, at 348.

223 The preamble to the final regulations notes the complex issues raised by unpaid cumulative dividends and invites comments on the issue.

223.1 HR Conf. Rep. No. 964, 101st. Cong., 2d Sess. 1095 (1990).

223.2 See, e.g., Ginsberg & Levin, Mergers, Acquisitions and Buyouts, Wolters and Kluwer (January 2011) at ¶ 1309.3.1(10) (treatment of cumulative dividends as "disguised" preferred OID would appear to represent a significant and unwarranted change in the Service's position).

224 For this purpose, "recapitalization" means a transaction described in Section 368(a)(1)(E).

225 Reg. § 1.305-7(c)(1). For this purpose, the value and liquidation preference are determined immediately following the recapitalization

226 See Reg. § 1.305-5(d), Ex. 2. In Private Letter Ruling 201308001, the taxpayer had one class of voting common stock outstanding. The taxpayer paid dividends on the common stock. The taxpayer permitted employees to purchase stock at a formula price, but to reduce the formula price and reduce the cost to employees of purchasing stock, the company proposed to amend its charter to provide two classes of common stock. One class would track a particular group of assets, while the other class would track another group of assets. Creditors of the taxpayer had recourse to all of the taxpayer's assets. Upon liquidation, the classes received the value of the assets in each respective category. Each new share had one vote per share and voted as a class on all matters. The taxpayer represented that the recapitalization was a single, isolated transaction. The Service ruled that the recapitalization would not be treated as a distribution of property to which Section 301 applied by reason of Sections 305(b) and 305(c).

227 Reg. § 1.305-5(d), Ex. 6. The example also notes that the same result would follow if the old preferred stock were exchanged in any reorganization described in Section 368(a)(1) for new preferred stock having substantially the same market value and no greater call price or liquidation preference than the old preferred stock.

228 Reg. § 1.305-7(c)(2). Value and preference are determined immediately following the recapitalization.

229 Reg. § 1.305-5(d), Ex. 1. This example also notes that the same result would occur if the fair market value of the common stock immediately following the recapitalization were $20 per share and each share of preferred stock were exchanged for one share of the new preferred stock and one share of common stock.

230 Similarly, if an increase in the redemption price of preferred stock is made because dividends were paid to common shareholders, a deemed distribution of additional preferred stock would result and be taxed under Section 305(b)(4).

231 Reg. § 1.305-5(d), Ex. 3.

232 Reg. § 1.305-5(d), Ex. 6.

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***1 Federal Taxation of Financial Instruments & Transactions**

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Part I. Equity Investments

Chapter 1. Stock Distributions Under Section 305

1.05 SPECIAL PROBLEMS RAISED BY CONVERTIBLE STOCK AND SECURITIES

For Section 305 purposes, the term "stock" includes rights to acquire stock, and the term "shareholder" includes the holder of a right to acquire stock. [233] Thus, the holder of an option or warrant to acquire stock from the issuing corporation is treated as a shareholder of the corporation, as is a holder of the corporation's convertible debt. Similarly, a distribution of rights to acquire stock in the distributing corporation is treated as a distribution of stock for Section 305 purposes.

Where these convertible securities are present, the specter of Section 305(b) is raised if a stock distribution is made to the shareholders holding stock into which the security is convertible. [234] Conversely, a change in the conversion ratio or price of convertible securities can give rise to a deemed distribution that is taxable under Section 305(b). Both categories of transactions are described below.

1.05[1] Distributions of Stock to Shareholders

Special concerns arise if a corporation has convertible securities outstanding and makes a distribution of stock or stock rights to its shareholders. In this event, the distribution can be taxable to the recipient if steps are not taken to prevent dilution in the convertible security holders' interests.

1.05[1][a] Impact on Recipient if Conversion Rights Are Not Adjusted

A corporation that has convertible securities outstanding can trigger Section 305(b)(2) if the corporation distributes a stock dividend with respect to the stock into which the instrument converts, and a full adjustment in the conversion ratio or price to prevent dilution to the holders of the convertible instrument is not made. In this instance, the recipient shareholder will experience an increase in proportionate interest in the earnings or assets of the corporation by reason of the stock dividend. Section 305(b)(2) applies if the corporation distributes property to any of the other shareholders, including the holders of the convertible instrument. Importantly, this property requirement may be easily met, since the payment of interest on a convertible debenture is treated as a distribution of property to a shareholder. [235]

When a stock distribution is made, the necessary adjustment in the conversion ratio or price is typically made pursuant to an antidilution formula contained in the terms of the convertible instrument. Two common formulas are the market price formula and the conversion price formula. Under the market price formula, a downward adjustment in conversion price is made to the extent that the corporation issues stock at a below-market price, regardless of whether the market price is higher or lower than the conversion price. Under the conversion price formula, a downward adjustment in conversion price is made to the extent that stock is sold below the conversion price, even if the price reflects full market value. [236] An adjustment under either of these or similar formulas normally should be sufficient to prevent application of Section 305(b)(2). [237] However, the regulations state that a full adjustment may not occur under the conversion price formula if a credit is given for stock issued at a price that exceeds the conversion price. The concern is that the credit may prevent a decrease in the conversion price which would otherwise be required under the formula if a stock dividend were made. [238]

***2** The regulations illustrate this principle through the following example. [239] Assume that a corporation has two classes of securities outstanding, convertible debentures and common stock, and that the corporation has 100 shares of common stock outstanding when the debentures are issued. Each debenture is interest-paying and convertible into common stock at a conversion price of $2. The debenture's conversion price is subject to reduction pursuant to the following formula:

A + B / X + Y = new conversion price

A = number of common shares outstanding at date of issue of debentures multiplied by the initial conversion price

B = consideration received upon issuance of additional common shares

X = number of common shares outstanding at date of issue of debentures

Y = number of additional common shares issued

Under the formula, common stock dividends are treated as issued for zero consideration. In addition, the conversion price is reduced if the formula produces a new price that is less than the existing price. However, the existing conversion price is never increased (even if the formula produces a higher conversion price), because this would only exacerbate the dilution. Finally, the formula works on a cumulative basis, since the numerator includes the consideration received upon the issuance of all common shares subsequent to the issuance of the debentures. Thus, the reduction effected by the formula because of a sale or issuance of common stock below the existing conversion price is limited by any prior sales made above the existing conversion price.

Assume that in Year 1, the corporation sells 100 common shares at $3 per share. In Year 2, the corporation declares a stock dividend of twenty shares to all holders of common stock. However, no adjustment to the conversion price of the debentures is made under the formula to reflect the stock dividend, because the prior sale of common stock at a price in excess of the conversion price offsets the reduction that would otherwise result. [240] Because of this failure to adjust the convertible holders' conversion price, an increase in proportionate interest of the common shareholders occurs by reason of the stock dividend. Moreover, since other shareholders received property (i.e., interest on the debenture that is treated as a dividend), the receipt of common stock is taxable under Section 305(b)(2). [241]

The cumulative nature of the formula in the illustration above prevented the adjustment in the conversion ratio and thus triggered Section 305(b)(2). If no sale of stock had occurred, the conversion price would have been adjusted (i.e., reduced) under the formula. [242] The price would fully reflect the stock dividend distributed to the common stockholders, and the distribution of

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common stock would not trigger Section 305(b)(2), because the proportionate interests of the common shareholders would not increase. [243]

***3** In addition, the regulations also illustrate the use of another formula for adjusting conversion prices. [244] This formula does not operate on a cumulative basis. Instead, in the case of any stock dividend, the conversion price in effect at the opening of business on the day following the dividend record date is simply reduced to take into account the shares being distributed. [245] Since the conversion price is reduced in all cases, it fully reflects the stock dividend distributed to the common shareholders. Section 305(b)(2), therefore, does not apply, because the distribution does not increase the proportionate interests of the common shareholders as a class.

1.05[1][b] Impact on the Convertible Holder if Adjustment Is Made

The regulations state that a deemed distribution under Section 305(c) does not arise if the conversion ratio of convertible preferred stock or debt is adjusted under a bona fide and reasonable adjustment formula, and the adjustment has the effect of preventing dilution to the convertible holders. [246] Thus, under the regulations, an adjustment under a market price, conversion price, or similar formula should not give rise to a deemed distribution of stock if it prevents dilution of the convertible holders' interest. [247] Stated differently, the adjustment serves only to preserve the convertible holders' predistribution interest in the distributing corporation and should not be taxable.

1.05[1][c] Required Timing of Adjustment

The adjustment to the convertible securities must be made within a particular time in order to prevent taxation of the common stock dividend. That is, the distributing corporation must either make the adjustment as of the date of the distribution of the stock dividend or elect to make the adjustment within the prescribed time provided. Specifically, if the distributing corporation makes the election, the adjustment must be made no later than the earlier of (1) three years after the date of the stock dividend or (2) that date when the aggregate stock dividends for which adjustment of the conversion ratio has not previously been made total at least 3 percent of the issued and outstanding stock for which stock dividends were distributed. [248]

Example 1-19

A corporation has two classes of stock outstanding—common and convertible preferred. The preferred is fully protected against dilution in the event of a stock dividend or stock split with respect to the common stock. However, the adjustment in the conversion ratio must be made at the earlier of (1) the date stock dividends equal 3 percent of the common stock issued and outstanding on the date of the first such stock dividend or (2) the date that is no later than 3 years after the date of the stock dividend. Cash dividends are paid annually on the preferred stock.

Assume the corporation pays a 1 percent stock dividend on the common stock in Year 1, another 1 percent stock dividend in Year 2, and another 1 percent stock dividend is paid in Year 3. The conversion ratio of the preferred stock is increased in Year 3 to reflect the three stock dividends paid on the common stock. The distributions of common stock are not subject to Section 305(b)(2), because the common shareholders did not increase their proportionate equity interest in the corporation. [249]

1.05[2] Deemed Distributions Involving Convertible Security Holders

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***4** Under Section 305(c), a change in conversion ratio or conversion price may give rise to a deemed distribution of stock. Thus, an increase in the conversion ratio can be treated as a distribution of stock to the security holder. On the other hand, a decrease in the ratio can be viewed as a stock distribution to the holders of the stock into which the instrument is convertible. The regulations, however, contain an exception which provides that if the conversion ratio of convertible preferred stock or debt is adjusted under a bona fide and reasonable adjustment formula, and the adjustment has the effect of preventing dilution, then a deemed distribution does not arise under Section 305(c) because of that adjustment. [250] However, if an adjustment to the conversion ratio of stock or debt is made to compensate for a taxable distribution of cash or property to the other shareholders, this exception does not apply and the adjustment gives rise to a deemed distribution of stock. [251]

Under this framework, if a conversion ratio on convertible stock or debt is reduced (or conversion price increased), a deemed distribution of stock to the shareholders holding stock into which the instrument converts results, assuming the exception above does not apply, because the adjustment caused an increase in their proportionate interest in the corporation. That deemed distribution is tested under the rules of Section 305(b) to determine if it is taxable.

Example 1-20

A corporation has Class A and Class B common stock outstanding. The Class B stock is convertible into Class A stock. The conversion ratio on the Class B increases if cash dividends are paid on the Class A stock and decreases if cash dividends are paid on the Class B stock. Assume that cash dividends are paid on the Class B, so that a decrease in the conversion ratio occurs. The decrease in the conversion ratio triggers a deemed distribution to the holders of the Class A stock, and this distribution is taxable under Section 305(b)(2), because cash dividends were paid to the Class B shareholders. [252]

Conversely, an increase in conversion ratio (or decrease in conversion price) would produce a deemed stock distribution to the holders of the convertible security, since they are entitled to acquire more stock. [253] The resulting deemed distribution may be taxable under Section 305(b).

Example 1-21

Assume the same facts as in Example 1-20, except that Class B shares convert into Class A at a conversion ratio that automatically increases each year. The corporation pays a cash dividend on the Class A, while the ratio on the Class B stock increases. The increase in the conversion ratio of the Class B stock is deemed to be a distribution of stock. Since a cash distribution was also made, the deemed stock dividend is taxable to the holders of Class B stock. [254]

***5** As indicated earlier, convertible debt is treated as stock for Section 305purposes, and the holder of such debt is treated as a shareholder. Thus, a creditor of a corporation may be in receipt of a taxable stock dividend under Section 305 if the conversion ratios or price on the debt is changed. This result was confirmed in Revenue Ruling 75-513, [255] where a corporation issued convertible debentures calling for an adjustment each year to the conversion ratio to reflect the distribution of cash dividends made to the holders of the corporation's common stock. Since the conversion ratio was increased, a deemed distribution was made to the convertible debtholders. This deemed distribution was taxable under Section 305(b)(2), because the increase was accompanied by a receipt of property (cash) by the common shareholders.

Importantly, a change in exercise price of warrants to acquire common stock may give rise to a deemed distribution. However, unless that distribution is matched with a distribution of property, Section 305(b)(2)would not apply. Finally, if the conversion

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ratio on convertible preferred stock is increased, the resulting deemed distribution is taxable under Section 305(b)(4), unless the exception for adjustments to reflect stock splits, stock dividends, or similar events applies. [256]

1.05[3] Proposed Regulations Concerning Convertible Securities

As noted previously, Section 305(c) can trigger a deemed distribution as a result of changes to the conversion ratio or price of a convertible security. Under Sections 305(b) and 305(c) and the regulations thereunder, Section 301 applies to such a deemed distribution if: (1) the applicable adjustment increases the proportionate interest of an actual shareholder or a deemed shareholder in the corporation's assets or earnings and profits; (2) such increase in proportionate interest has a result described in Section 305(b); and (3) the anti-dilution exception of Regulation Section 1.305-7(b)(1) does not apply. Significant uncertainty, however, has arisen as to the amount and timing of a deemed distribution resulting from a conversion ratio adjustment. The current regulations are unclear as to whether such a deemed distribution should be treated as a distribution of a right to acquire stock or as a distribution of the actual stock to which the right relates. The current regulations are also unclear as to the timing of such a distribution, and questions have been raised by withholding agents regarding their withholding obligations on deemed distributions to non-U.S. investors. [257] On April 13, 2016, the Treasury published proposed regulations (the 2016 proposed regulations) that would amend the current regulations under Section 305 (and the related withholding provisions) to address these concerns. [258]

The 2016 proposed regulations would confirm that under Section 305(c), an applicable adjustment is treated as a distribution of stock to which Sections 305(b) and 301 apply if such transaction increases a shareholder's proportionate interest in the distributing corporation and the distribution has the result described in Section 305(b). Depending on the facts presented, the distribution may be deemed to be made in shares of actual stock or in additional rights to acquire stock (which, in either case, may be common or preferred stock). [259] The 2016 proposed regulations would reconfirm that an applicable adjustment that is made pursuant to a bona fide, reasonable adjustment formula (including, but not limited to, an applicable adjustment made to compensate for a distribution of stock to another shareholder) and that has the effect of preventing dilution of the proportionate interest of the holders of actual stock or rights to acquire stock does not result in a deemed distribution of stock. An applicable adjustment, however, that is made to compensate for a taxable distribution of cash or property to another shareholder is not made pursuant to a bona fide adjustment. [260]

1.05[3][a] Amount of Deemed Distribution

***6** Under Section 305(c), if an applicable adjustment has the effect of increasing a deemed shareholder's proportionate interest in the distributing corporation, and if such increase has the effect described in Section 305(b), the applicable adjustment is a deemed distribution to the deemed shareholder (i.e., the holder of the right) of a right to acquire stock, and Section 301 applies to the deemed distribution. [261] In other words, the increase is an applicable adjustment and a deemed distribution of additional rights to acquire stock to the holders of the rights to acquire stock. Under the 2016 proposed regulations, the amount of the deemed distribution would be the excess of (1) the fair market value of the right to acquire stock immediately after the applicable adjustment over (2) the fair market value of the right to acquire stock without the applicable adjustment. [262]

Conversely, under the terms of a convertible debt instrument or other right to acquire stock, a payment of cash or property to the holder may cause a reduction in the number of shares the holder would receive upon conversion or exercise. Such a reduction is an applicable adjustment that increases the actual shareholders' proportionate interests in the assets or earnings and profits of the corporation. Thus, the applicable adjustment results in a deemed distribution of stock to the actual shareholders, and Section

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301 could apply to the deemed distribution. [263] Under the 2016 proposed regulations, the amount of this deemed distribution in this case would be the fair market value of the stock deemed distributed. [264]

1.05[3][b] Timing of Deemed Distribution

When an applicable adjustment results in a deemed distribution, the distribution is deemed to occur on the earlier of: (1) the time such applicable adjustment occurs in accordance with the terms of the underlying instrument or (2) the date of the distribution of cash or property that results in the deemed distribution. If the underlying instrument does not set forth the date and time the applicable adjustment occurs, and the right relates to publicly traded stock, the deemed distribution would occur immediately prior to the opening of business on the ex-dividend date for the distribution of cash or property that results in the deemed distribution. If the instrument does not set forth the date and time of the applicable adjustment and the right relates to nonpublicly traded stock, the deemed distribution occurs on the date that the holder is legally entitled to the distribution of cash or property that results in the deemed distribution. [265]

1.05[3][c] Withholding on a Deemed Distribution and New Exception for Deemed Distributions

The 2016 proposed regulations also would provide guidance to withholding agents regarding their obligations to withhold on deemed distributions under Section 305(c). The 2016 proposed regulations would clarify that a withholding agent has an obligation to withhold on a deemed distribution that is made on a security. [266] The proposed regulations, however, would allow a withholding agent (other than the issuer) to benefit from a new exception to withholding for deemed distributions of stock or a right to acquire stock. Under this new exception, a withholding agent (other than the issuer) would have an obligation to withhold on such a deemed distribution only if, before the due date for filing Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, with respect to the calendar year in which the deemed distribution occurred, either: (1) the issuer meets its reporting requirements described later or (2) the withholding agent has actual knowledge that a deemed distribution has occurred, in which case the obligation to withhold would not arise until January 15 of the year following the calendar year of the deemed distribution. [267]

***7** Once a withholding requirement has been triggered, a withholding agent would have an obligation to withhold on a deemed distribution generally on the earliest of: (1) the date on which a future cash payment is made with respect to the security; (2) the date on which the security is sold, exchanged, or otherwise disposed of (including a transfer of the security to another account not maintained by the withholding agent or a termination of the account relationship); or (3) the due date for filing Form 1042 with respect to the calendar year in which the deemed distribution occurred. [268]

A withholding agent would be permitted to treat certain foreign entities (i.e., qualified intermediaries, withholding foreign partnerships, withholding foreign trusts, and U.S. branches treated as U.S. persons) as assuming primary withholding responsibilities for a deemed distribution on a specified security only if: (1) the withholding agent provides the foreign entity with a copy of the issuer statement described later or (2) the issuer has met the public reporting requirements described later. The foreign entity would have an obligation to withhold on the deemed distribution only if it receives a copy of the issuer statement or if the issuer has met the public reporting requirements by the due date for filing Form 1042 with respect to the calendar year in which the deemed distribution occurred. A withholding agent that fails to provide a copy of the issuer statement to a foreign entity (in the absence of public reporting) would not be permitted to treat the foreign entity as having assumed primary withholding responsibilities for the deemed distribution and would therefore have to withhold and report based on the information that it has regarding the recipient of the deemed distribution. [269]

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1.05[3][d] Issuer Reporting Under Section 6045B

To facilitate broker reporting of a security's adjusted basis to the holder of the security under Section 6045, Section 6045B provides that, according to the forms or regulations prescribed by the Secretary of the Treasury, an issuer of a specified security (e.g., stock, a convertible debt instrument, or a warrant) must report certain information relating to an organizational action that affects the basis of the security to both the Service and the holders of the security. Under these provisions, an issuer must file Form 8937, Report of Organizational Actions Affecting Basis of Securities, with the Service by the earlier of forty-five days after the organizational action or January 15 of the calendar year following the organizational action. In addition, the issuer must send a written statement to holders by January 15 of the calendar year following the organizational action. In lieu of these filing procedures, an issuer is permitted to post the required information on its public website by the due date for reporting the issuer return to the Service.

Under the current regulations, however, an issuer is not required to send a statement to exempt recipients, such as C corporations and foreign persons, nor is an issuer required to file an issuer return if the issuer reasonably determines that all of the holders of the security are exempt recipients. The 2016 proposed regulations would remove this exemption and provide that an issuer is required to report the required information regarding any deemed distributions even if the record holders of a security are exempt recipients. This change is apparently intended to address concerns of broker and withholding agents about the difficulty of complying with their reporting and withholding obligations in the absence of information about the fact and amount of a deemed distribution under Section 305(c) resulting from an applicable adjustment. [270]

1.05[3][e] Proposed Effective Date

***8** The 2016 proposed regulations would apply to deemed distributions occurring on or after the date these rules are finalized. A taxpayer, however, may rely on these proposed regulations for deemed distributions under Section 305(c) that occur prior to such date. For purposes of determining the amount of a deemed distribution to a deemed shareholder occurring prior to the date of publication, a taxpayer may determine the amount of the deemed distribution by treating such distribution either as a distribution of a right to acquire stock or as a distribution of the actual stock to which the right relates. [271]

Footnotes

233 IRC § 305(d).

234 For convenience, a reference to convertible securities includes a reference to an option or warrant to acquire stock, unless the context indicates otherwise.

235 Reg. § 1.305-3(b)(3). See supra ¶ 1.03[2][d].

236 For purposes of the stock of either formula, a stock dividend is considered a sale for zero consideration.

237 Cf. Reg. § 1.305-7(b)(2) (examples showing the impact to the convertible holder).

238 Reg. § 1.305-3(d)(1)(i). On the other hand, if there were no prior sales of stock above the conversion price, a full adjustment would be made under the formula and no change in proportionate interest would arise.

239 Reg. § 1.305-3(d)(1)(ii), Ex. (a).

240 The conversion price increased under the formula as follows: ((100 x $2) + $300) ÷ (100 + 120) = $500220 = $2.27

241 Reg. § 1.305-3(d)(1)(ii), Ex. (b).

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242 Application of the antidilution formula in this case would give rise to an adjustment in the conversion price as follows: ((100 x $2) + $0) ÷ (100 + 20) = $ 200120 = $1.67

243 Reg. § 1.305-3(d)(1)(ii), Ex. (c). Similarly, if consideration is to be received in connection with the issuance of stock, such as in the case of a rights offering or a distribution of warrants, the fact that the consideration is taken into account in making the antidilution adjustment does not preclude a full adjustment. For example, assume that the corporation in the text distributes to its shareholders rights entitling the shareholders to purchase a total of twenty shares at $1 per share. Application of the antidilution formula would produce an adjustment in the conversion price as follows: ((100 x $2) + ($20 x $1) ÷ (100 + 20) = $220120 = $1.83

The conversion price, being reduced from $2 to $1.83, fully reflects the distribution of rights to purchase stock at a price lower than the conversion price. Hence, the distribution of the rights would not be subject to Section 305(b)(2), because the distribution does not increase the proportionate interests of the common shareholders as a class. Reg. § 1.305-3(d)(1)(ii), Ex. (d).

244 Reg. § 1.305-3(d)(1)(ii), Ex. (e).

245 The reduction is determined by multiplying the conversion price by a fraction, the numerator of which is the number of shares of common stock outstanding at the close of business on the record date and the denominator of which is the sum of the shares so outstanding and the number of shares constituting the stock dividend.

246 Reg. § 1.305.7(b)(1). This exception does not apply if an adjustment to the conversion ratio of stock or debt is made to compensate for a taxable distribution of cash or property to other shareholders. The Service has ruled that a change in the conversion ratio of preferred to reflect the distribution to common shareholders of stock of a subsidiary corporation, the latter distribution being nontaxable under Section 355, did not result in a deemed distribution to the preferred shareholders. Rev. Rul. 77-37, 1977-1 CB 85.

247 Reg. § 1.305-7(b)(2).

248 The election is made by filing with the income tax return for the taxable year during which the stock dividend is distributed (1) a statement that an adjustment will be made as provided by that subdivision and (2) a description of the antidilution provisions under which the adjustment will be made.

249 Reg. § 1.305-3(e), Ex. 5.

250 Id.

251 Id. (describing cash or property distributions taxed as a dividend or dividend-like transaction). The Service has ruled that a change in the conversion ratio of preferred to reflect the distribution to common shareholders of stock of a subsidiary corporation, the latter distribution being nontaxable under Section 355, does not result in a deemed distribution to the preferred shareholders. Rev. Rul. 77-37, 1977-1 CB 85.

252 Reg. § 1.305-3(e), Ex. 7.

253 See House Report, supra note 18, at 114–115; Senate Report, supra note 18, at 153–154.

254 Reg. § 1.305-3(e), Ex. 6. If the Class B stock were preferred stock, the same result would be achieved under Section 305(b)(4) (deemed distribution under Section 305(c) on preferred stock).

255 Rev. Rul. 75-513, 1975-2 CB 114.

256 See supra ¶ 1.04[1][b].

257 In particular, withholding agents commented that ambiguities in the current law have made it difficult for them to satisfy their withholding obligations. Specifically, withholding agents commented that these deemed distributions often occur when there is no cash payment that corresponds to the deemed distribution, which makes it difficult for them to satisfy their withholding obligation on the date of the deemed distribution. In addition, withholding agents commented that they often lack knowledge of the fact that a deemed distribution on a security has been made and are therefore unable to withhold on the date of the deemed distribution. See preamble to the 2016 proposed regulations, REG-133673-15, 81 Fed. Reg. 21795 (Apr. 13, 2016).

258 Notice of Proposed Rulemaking, Deemed Distributions Under Section 305(c) of Stock and Rights to Acquire Stock, REG-133673-15, 81 Fed. Reg. 21795 (Apr. 13, 2016).

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259 Prop. Reg. § 1.305-7(b)(1). An "applicable adjustment" would be defined to include an adjustment to a right to acquire stock, including a change in conversion price, conversion ratio, or number of shares to be acquired. See Prop. Reg. § 1.305-7(a).

260 Prop. Reg. § 1.305-7(c)(3).

261 Prop. Reg. § 1.305-7(c)(1). Applicable adjustments that can have this effect include, with respect to a convertible instrument, an increase in the conversion ratio or the number of shares of stock to be received upon conversion or a reduction in the conversion price. Id.

262 Prop. Reg. § 1.305-7(c)(4)(i). In determining the fair market value of a right to acquire stock, any particular facts pertaining to the deemed shareholder's rights, including the number of actual shares of stock or rights to acquire stock held by such deemed shareholder, would be disregarded. Prop. Reg. § 1.305-7(c)(4)(iii).

263 Prop. Reg. § 1.305-7(c)(2). Applicable adjustments that can have this effect include, with respect to a convertible instrument, a reduction in the conversion ratio or in the number of shares to be received upon conversion, or an increase in the conversion price. Id.

264 Prop. Reg. § 1.305-7(c)(4)(ii). The amount of the deemed distribution in this case is determined in accordance with Proposed Regulation Section 1.305-3(e), Exs. 6 and 7 (relating to deemed distributions to shareholders resulting from certain redemptions of stock from other shareholders). See also Tax Revenue Act of 1969: Hearings on H.R. 13270 Before the House Ways and Means Comm., 91st Cong. 1st Sess., pt. 14, 5196–5198 (1969).

265 Prop. Reg. § 1.305-7(c)(5).

266 Prop. Reg. § 1.1441-2(d)(1)(ii).

267 Prop. Reg. § 1.1441-2(d)(4)(i).

268 Prop. Reg. § 1.1441-2(d)(4)(ii).

269 Prop. Reg. § 1.1441-2(d)(4)(iii).

270 Prop. Reg. § 1.6045B-1(i).

271 Prop. Reg. §§ 1.305-1(e), 1.305-3(f), 1.305-7(g).

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CHECKPOINT

Ajay Gupta
Financial Products Taxation
Reading #3

Dividend Stripping

Code: §§ 1(h)(11)(B)(iii); 246(c); 901(k), (l).

Stobierski, "What is Arbitrage? 3 Strategies to Know," HBS Online (July 2021).

H. David Rosenbloom, "The David R. Tillinghast Lecture: International Tax Arbitrage and the 'International Tax System,'" 53 Tax L. Rev. 137 (2000). (Optional)

Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001).

IES Industries v. United States, 253 F.3d 350 (8th Cir. 2001).

H.R. Rep. No. 105-148 (extract).

Discussion Questions:

1. In an economic sense, what does the term "arbitrage" mean?

2. What might the term "tax arbitrage" mean?

3. Did Compaq or IES engage in economic arbitrage?

4. Does either case present a tax arbitrage transaction?

HBS Online July 2021

WHAT IS ARBITRAGE? 3 STRATEGIES TO KNOW

Tim Stobierski

In the world of alternative investments, there are several strategies and tactics you can employ. These strategies often differ from the typical “buy and hold” tactics leveraged by most long-term stock and bond investors—and are usually more complicated.

Arbitrage is one alternative investment strategy that can prove exceptionally profitable when leveraged by a sophisticated investor. It also carries risks you must consider. To effectively include arbitrage in your alternative investment strategy, it’s critical to understand the nuances and risks involved.

Below is an overview of arbitrage, including a look at three types you should know: pure arbitrage, merger arbitrage, and convertible arbitrage.

WHAT IS ARBITRAGE?

Arbitrage is an investment strategy in which an investor simultaneously buys and sells an asset in different markets to take advantage of a price difference and generate a profit. While price differences are typically small and short-lived, the returns can be impressive when multiplied by a large volume. Arbitrage is commonly leveraged by hedge funds and other sophisticated investors.

There are several types of arbitrage, including pure arbitrage, merger arbitrage, and convertible arbitrage. Global macro is another investment strategy related to arbitrage, but it’s considered a different approach because it refers to investing in economic changes between countries.

TYPES OF ARBITRAGE

1. Pure Arbitrage

Pure arbitrage refers to the investment strategy above, in which an investor simultaneously buys and sells a security in different markets to take advantage of a price difference. As such, the terms “arbitrage” and “pure arbitrage” are often used interchangeably.

Many investments can be bought and sold in several markets. For example, a large multinational company may list its stock on multiple exchanges, such as the New York Stock Exchange (NYSE) and London Stock Exchange. Whenever an asset is traded in multiple markets, it’s possible prices will temporarily fall out of sync. It’s when this price difference exists that pure arbitrage becomes possible.

Pure arbitrage is also possible in instances where foreign exchange rates lead to pricing discrepancies, however small.

Ultimately, pure arbitrage is a strategy in which an investor takes advantage of inefficiencies within the market. As technology has advanced and trading has become increasingly digitized, it's grown more difficult to take advantage of these scenarios, as pricing errors can now be rapidly identified and resolved. This means the potential for pure arbitrage has become a rare occurrence.

2. Merger Arbitrage

Merger arbitrage, also called risk arbitrage, is a type of arbitrage related to merging entities, such as two publicly traded businesses.

Generally speaking, a merger consists of two parties: the acquiring company and its target. If the target company is a publicly traded entity, then the acquiring company must purchase the outstanding share of said company. In most cases, this is at a premium to what the stock is trading for at the time of the announcement, leading to a profit for shareholders. As the deal becomes public, traders looking to profit from the deal purchase the target company's stock—driving it closer to the announced deal price.

The target company's price rarely matches the deal price, however, it often trades at a slight discount. This is due to the risk that the deal may fall through or fail. Deals can fail for several reasons, including changing market conditions or a refusal of the deal by regulatory bodies, such as the Federal Trade Commission (FTC) or Department of Justice (DOJ).

In its most basic form, merger arbitrage involves an investor purchasing shares of the target company at its discounted price, then profiting once the deal goes through. Yet, there are other forms of merger arbitrage. An investor who believes a deal may fall through or fail, for example, might choose to short shares of the target company's stock.

3. Convertible Arbitrage

Convertible arbitrage is a form of arbitrage related to convertible bonds, also called convertible notes or convertible debt.

A convertible bond is, at its heart, just like any other bond: It's a form of corporate debt that yields interest payments to the bondholder. The primary difference between a convertible bond and a traditional bond is that, with a convertible bond, the bondholder has the option to convert it into shares of the underlying company at a later date, often at a discounted rate. Companies issue convertible bonds because doing so allows them to offer lower interest payments.

Investors who engage in convertible arbitrage seek to take advantage of the difference between the bond's conversion price and the current price of the underlying company's shares. This is typically achieved by taking simultaneous positions—long and short—in the convertible note and underlying shares of the company.

Which positions the investor takes and the ratio of buys and sells depends on whether the investor believes the bond to be fairly priced. In cases where the bond is considered to be cheap, they usually take a short position on the stock and a long position on the bond. On the other hand, if the investor believes the bond to be overpriced, or rich, they might take a long position on the stock and a short position on the bond.

ONE TOOL IN THE ALTERNATIVE INVESTMENT ARSENAL

Arbitrage, in its many forms, can be an effective tool for investors seeking low-risk yields. Because yield is often small, it requires high volumes to realize the benefits of arbitrage and generate enough profit to overcome transaction fees. For this reason, arbitrage is generally not a strategy individual investors can leverage for themselves. It is, however, often used by hedge funds and other institutional investors that are capable of high volumes.

While effective, arbitrage is just one tool among many when it comes to alternative investments. If you're considering a career in alternative investments, it's important to understand all of the potential strategies you can leverage for your clients. Taking an online course, such as Alternative Investments, is an excellent means of gaining the knowledge you need to be successful.

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THE DAVID R. TILLINGHAST LECTURE INTERNATIONAL TAX ARBITRAGE AND THE "INTERNATIONAL TAX SYSTEM"

I. Introduction

In 1986, a curious statement about international tax policy emanated from the Senate Finance Committee:

The committee does not believe that the United States Senate wittingly agreed to an international tax system where taxpayers making cross-border investments, and only those taxpayers, could reduce or eliminate their U.S. corporate tax through self-help and gain an advantage over U.S. persons who make similar investments. [1]

At the time, the Committee was considering so-called "dual resident companies"--corporations whose losses might be used simultaneously to reduce taxable income of a related U.S. corporation and another related corporation in another country. The committee saw tax evil here, and its reaction and reasoning form the springboard for much of the discussion set forth below. The statement quoted above, however, is worthy of consideration in its own right.

More specifically: What, exactly, is this "international tax system" that the Committee invoked? Is it real? Currently functioning? The existence of overarching principles of international taxation into which U.S. law somehow fits, with which the U.S. Senate might be called upon to "agree," qualifies as news. [2] Is there an imperative calling for some measure of international harmonization in matters of ***138** taxation, or should the Committee's comment be regarded as wishful thinking?

It may be useful to recall some first principles here. In U.S. eyes, a "tax" is a levy requiring a "compulsory payment pursuant to the authority of a . . . country to levy taxes" for which the payor receives no "specific economic benefit." [3] In return for the payment of a tax, payors receive the general benefit of government. Clearly, it is possible to conceive of a tax in this sense that is wholly, or partially, arbitrary. A nation, for example, could effectively run a reverse lottery, choosing for assessment at random among persons subject to its jurisdiction. Less dramatically, it could adopt arbitrary deductions or credits based on educational level, geographical location, occupation, or any number of other attributes or actions of the taxpayer. Of course, most countries attempt to apply rules of taxation that are not arbitrary, at least in their view. And seemingly arbitrary elements in a tax system may reflect considerations that, on closer inspection, are not arbitrary at all. [4]

Even without arbitrariness, a system of taxation necessarily operates on the basis of numerous detailed preconditions, the terms of which may--indeed, must--be expected to differ from country to country. Consider, for example, the income tax (as I will continue to do, throughout this Article). The income tax will not apply unless the nature of a given inflow is such as to qualify it as income, and often the operation of income tax rules will depend further upon the particular type, character, and source of the income. The person called upon to pay must be the person found responsible for the income, that is, the appropriate taxpayer. Issues relating to the status of that taxpayer--as resident, nonexempt, and the like--have to be considered. The responsibility of the taxpayer must arise within the time period for which the tax is imposed, and the circumstances must be such that the income

has ripened and a liability to pay tax has been triggered. Entitlement to subtractions (deductions) in reaching the tax base is likely to depend on showing that outflows are correctly attributed to the taxpayer, that the deductions properly fall within the time period in question, and so on. There also may be credits for which a series of similar inquiries is necessary. Computational issues--how much income, how many deductions, how many credits--add to the list. All of these elements comprise the "stuff" of the tax.

***139** No one in the United States should be surprised that other jurisdictions have addressed these matters on their own terms and established rules that do not always match our own. The Germans do not have an exquisitely subdivided limitation on the foreign tax credit. [5] The British assign corporate residence according to where an entity is managed and controlled, not only according to where it is organized. [6] Japan does not have anything like the intricate U.S. rules for determining when a trust constitutes a taxpayer independent of either its grantor or its beneficiary. [7] And few countries other than the United States are likely any time soon to draw the line between a taxable entity, on the one hand, and one whose income is taxable to its owners, on the other, on the basis of a choice exercised by the entity on a piece of paper. [8]

Taxation under a rule of law (a concept not unique to the United States) depends upon a number of individual subrules, and there is nothing preordained or inevitable about what those subrules should be. The choices are plentiful, even if choices serving purposes other than the direct tax purpose are disregarded. It would be amazing if there was greater uniformity across national boundaries--if countries generally defined "resident" in the same way, or "corporation," or "stock." In fact, it is fairly amazing that the taxing jurisdictions of the world, with their diverse political and economic systems, have reached a point of sufficient understanding in matters of law and taxation that the concepts of "residence," "corporation," and "stock" are generally comprehensible almost everywhere.

We like to think that tax rules in the United States have been adopted and refined rationally and with at least a secular tendency toward economic soundness, administrability, and openness. But we hardly have a monopoly on correctness or consistency. It is not self-evident that a corporation organized under U.S. law but all of whose assets, personnel, and income are situated outside the United States should be taxable on worldwide income as a U.S. resident. [9] Nor is the multi-factor formula that our courts employ to differentiate debt from equity derived from some immutable source. [10] We cannot maintain with a straight face that we pursue substance while other countries look to form, since there are large areas of U.S. tax law (subchapter C, for one) where form largely triumphs over substance.

***140** Other nations pursue their own ways, for their own reasons. In many cases, a dispassionate analysis of those ways and reasons would conclude that they produce results at least as valid as the results we have reached in answering the same or similar questions. Can anyone doubt the force of a "managed and controlled" test for entity residence? We have opted for exclusive use of the more administrable place-of-incorporation standard, [11] but we cannot realistically maintain that that is because we are consistent in the choice of administrability over economic substance. If we were, we probably would have decided that the source of royalty income should be linked to the payor's residence, as opposed to the far more cumbersome, but more economically accurate, place-of-use rule that we have adopted. [12] Our criteria for distinguishing debt from equity may represent the ultimate pursuit of economic reality, [13] but they are surely the bane of the tax administrator. In fact, we (like most other countries) have wandered about in our tax policy choices, sometimes favoring substance over form, and sometimes giving the nod to considerations of administrability. In some cases, we have vacillated, or provided rules that appeared clear at the outset but that subsequent developments rendered murky. And there are many instances where our rules have not remained under a firm policy-based control, particularly as the underlying factual inputs have mutated with advancing technology. [14] Of course, other countries also face changing circumstances and, even if we were at the same point at any given time, there is little reason to believe we would remain there for long. [15]

This all seems simple, obvious. Countries differ in regard to the many rules of law that make up any system of taxation. And, since taxpayers everywhere can be expected to try to keep their tax burdens to a minimum, it follows naturally that they will study the rules of individual countries and seek to turn them to their advantage. When taxpayers are engaged in cross-border business, the effort will involve a focus on differences in the applicable rules. Taxpayers that comply with all the rules, while benefiting to the maximum from each of them, will be the most successful at global tax minimization.

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Certain implications of that minimization, and the focus on differences among countries, have been a source of concern for U.S. tax ***141** policymakers in Congress, Treasury, and the Service. Yet, the basis for this concern is not clear and its justification seems questionable. That basis and that justification appear not to have received the examination they deserve.

II. The Ascendancy of "International Tax Arbitrage"

The implications of differences among country tax systems have come into sharp focus in recent years, especially following enactment of the Tax Reform Act of 1986. [16] In part, this is because of a dramatic change in the most critical factor in U.S. international tax planning--the corporate tax rate. With the decline of that rate to 35%, [17] the relative importance of other countries' tax systems has increased commensurately. In addition, Congress gradually has limited opportunities to save taxes on income from cross-border economic activity by making creative use of the chinks in U.S. domestic law. Thus, several of the principal landmarks in planning for a U.S. multinational company, particularly the anti-abuse regime of subpart F, [18] the transfer pricing rules, [19] and the limitation on the foreign tax credit, [20] have been tightened and refined, so that home-grown solutions for problems encountered abroad have become scarcer.

It is true that hordes of "investment bankers" still spend many hours scouring the Code and regulations for fault lines from which "structured products" can be developed. These efforts depend largely, if implicitly, upon the audit lottery, but they still can be highly rewarding. Even when the plans come to light, a court may be persuaded to adopt a reading of law that is either blind to what is going on, impervious to considerations of public policy, or both. [21]

The effort to probe for weakness in the U.S. rules is not, however, dependable, because neither the Service nor the courts can be counted on to accept without protest the nuggets of planning material mined in the statutory and regulatory text. In addition to the threat posed by fill-in-the-blank statutory rules, such as § 7701(l) (relating obscurely to "any multiple-party financing transaction"), [22] there are pesky nonstatutory doctrines that the planning often ignores, which can be invoked ***142** even when the rules seem clear. [23] And problems can arise for even the best laid plans when implementation becomes slack and the concept underlying the plan (say, distinguishing stock from debt) is inherently problematic. [24]

One result has been increasing taxpayer interest in "international tax arbitrage"--a lofty term that refers to taking advantage of differences among country tax systems, usually differences in addressing a common tax question. [25] What is debt in Norway may be equity for us. If so, a distribution will be deductible interest for the Norwegian payor but a dividend bringing home foreign tax credits to the United States. A taxpayer may own depreciable property for U.S. purposes, while the counterparty to a transaction is the owner for Japanese tax purposes and therefore entitled to depreciation deductions under Japanese law. One airplane, two owners, two sets of deductions. [26]

The list goes on. The United States sees one taxpayer, by reason of the check-the-box regime or otherwise; the other country sees two. We find ownership in one person, and a secured financing; they find a transfer of ownership to another person whom we perceive as a lender. [27] We say the true borrower is the shareholder who guaranteed the debt; they say the debtor is the corporation that signed the loan instrument. [28] The result is not a breach of U.S. rules, for there is no such breach (although the effort to meet foreign requirements may require massaging of facts, and in that process the application of U.S. law may pass from clear to arguable). [29] The goal is to adhere, insofar as possible, to those rules while structuring the situation so as to meet the entirely different rules that obtain in the other country or countries. ***143** If the effort is successful, tax benefits will flow in the United States and at least one other country. [30]

This will result in obvious economic benefits beyond those that any single country having a tax interest in the transaction or situation would accord if the transaction or situation did not have a cross-border element. Potentially, the rewards are both richer and more secure than the effort to identify and exploit weaknesses in the tax laws of either the United States or the other country. As noted, we have attempted to discourage such exploitation in the United States, and other countries may have general anti-

abuse rules ("abus de droit") that can be invoked when tax planning is viewed as going too far. The beauty of international tax arbitrage, when practiced most skillfully, is that none of the objections to aggressive or abusive tax planning should apply anywhere because, from the vantage point of any single country, there is neither aggressiveness nor abuse. [31]

In its purest sense, the technique may be used to duplicate (in some cases, triplicate) tax benefits. The dual resident company and the double dip lease permit deductions to be claimed in more than one country. The unrelated income against which the deductions are applied is subject to tax in just one country; thus, a single transaction or arrangement gives rise to independent benefits in two or more countries. The same goal can be attained with imputation or foreign tax credits, which the laws of two or more countries may permit to be claimed independently in each country. [32] In some cases, a different view regarding the nature of an instrument, and consequently, a payment, may allow different treatment in different tax jurisdictions; this is the case involving the dividend that another country perceives as an interest payment. [33]

The most recent high-visibility example of international tax arbitrage was typical of this last type of transaction. Notice 98-11 [34] pertains to the exploitation of differing views of what is, and is not, a ***144** taxable entity; the check-the-box rules permit U.S.-based taxpayers to create entities recognized abroad whose existence the United States does not acknowledge (and, for that matter, vice versa). This tool easily gives rise to deductions allowable under foreign law with no commensurate income inclusion in the United States. The situations reported in Notice 98-11 are in this sense akin to situations in which a foreign country sees a deductible insurance premium while U.S. law finds no insurance and sees either a nontaxable distribution or a dividend carrying foreign tax credits with it.

There is an undeniable elegance to these arrangements. But elegance by itself is not a satisfactory reason for singling out these examples of tax arbitrage from other, more traditional forms of planning. If a foreign country allows a resident parent corporation to borrow and pay deductible interest, to use the borrowed funds to capitalize a subsidiary in a low-tax jurisdiction, and to have that subsidiary lend funds to a U.S. enterprise with no consequences in the home country of the parent (thus generating two interest deductions and only a single income inclusion, and that subject to a low tax rate), the effect would appear to be no different in substance from the dual resident company. More broadly, as long as the arbitrage hews to the rules in each affected country, it is hard to identify the difference between the more elegant examples and any situation in which a foreign country simply allows a tax benefit that the United States does not.

International tax arbitrage thus seems to flow seamlessly into the broader concept of reducing taxation worldwide as much as the laws of nations allow. The concept can be narrowed, but it is not clear that the narrowing achieves a meaningful analytical advance. And, although it may be observed that international tax arbitrage points in the direction of international nontaxation of income, that begs the issue. It implies that there is such a thing as international income, and that it is the task of someone--some nation--to ensure that tax applies to that income somewhere. (In all probability, this is one concept underlying the "international tax system" that the Senate Finance Committee invoked in 1986.) In fact, the longer one stares at recent examples of international tax arbitrage, the more difficult it becomes to identify a discrete subject. More troubling, the longer one performs this exercise, the less clear it is that anything should or can be done about it.

III. Is There a General Problem Here?

Congress apparently thinks--or, to be more accurate, at the time of the 1986 Act, it apparently thought--there is. That seems to be the meaning of congressional action and legislative history with respect to ***145** dual resident companies addressed in § 1503(d). [35] The 1986 experience is particularly interesting for present purposes, because the congressional materials on DRCs are far more explicit than any subsequent materials issued by Congress, Treasury, or the Service on any other example of international tax arbitrage.

The Senate Finance Committee, which initiated the congressional action in 1986, described the DRC issue as follows:

[A] corporation may be at the same time a U.S. resident and a resident of another country. Such companies are sometimes refered to as "dual resident companies." A dual resident company is taxable in both countries on its worldwide income (or

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it can deduct its worldwide losses). In addition, if the company is a resident of both the United States and either the United Kingdom or Australia, it is able, in effect, to use its losses to offset the income of commonly owned corporate residents in the two countries. (The committee is aware of the ability to share losses in this way only in the case of Australia and the United Kingdom; this ability may occur in other cases as well.) In general, neither of these countries taxes the active business income of foreign corporations that operate solely abroad.

Corporate groups attempt to isolate expenses in dual resident companies so that, viewed in isolation, the dual resident company is losing money for tax purposes. This isolation of expenses allows, in effect, the consolidation of tax results of one money-losing dual resident corporation with two profitable companies, one in each of two countries. This use of one deduction by two different corporate groups is sometimes referred to as "double dipping." The profitable companies report their income to only one country. [36]

According to the Committee, "[l]osses that a corporation uses to offset foreign tax on income that the United States does not subject to tax should not also be used to reduce any other corporation's U.S. tax." [37] The Committee thus found it offensive for a single tax occurrence ***146** (a loss), normally and properly deductible on a U.S. tax return, to give rise as well to a deduction under foreign law that was usable against income not subject to U.S. taxation. The ex cathedra tone of the pronouncement implies that its rationale is obvious. Is it?

The Finance Committee was motivated by a concern that "double dipping" could give an advantage to potential foreign acquirers of U.S. businesses. The advantage presumably works against potential domestic acquirers of such businesses, who do not have income in two taxing jurisdictions and thus cannot take advantage of the "double dip." As the Committee observed, "denial of double dipping to foreign-owned businesses that operate in the United States is necessary to end U.S. discrimination against U.S.-owned businesses that operate in the United States." [38] The concern was that a DRC might allow foreign persons to make investments in the United States with a negative marginal (worldwide) tax rate. "The committee believes that the dual resident company device creates an undue incentive for U.K. corporations (and Australian corporations) to acquire U.S. corporations and otherwise to gain an advantage in competing in the U.S. economy against U.S. corporations." [39]

In response to the argument that "the United States should not pay attention to the tax treatment that foreign countries apply to U.S. corporations," the Finance Committee replied that "[t]he United States frequently takes foreign taxation into account." It noted that "in particular, in allowing a foreign tax credit, the United States carefully considers the tax system of foreign countries." [40]

The Committee accordingly proposed that losses of a foreign-owned DRC not be allowed to reduce the income of other U.S. members of the affiliated group. Obviously, the focus here was inbound investment, and the potential for competition between foreign investors and similarly situated U.S. persons. In fact, competition concerns represent a common thread of U.S. tax policy affecting U.S. investment by foreign persons. Such concerns undeniably have informed the tax regime applicable to foreign persons engaged in a U.S. trade or business or deemed to be so engaged. [41]

In conference, however, the statutory remedy for DRCs (changed in various technical respects) was broadened to reach outbound investment--companies ultimately owed by U.S. persons. The conferees made this change because they believed it was fair: "[t]he conferees are not aware of a case where the use of one company's ***147** deduction by two other companies in two tax jurisdictions makes sense as a matter of tax policy." [42] In addition, the conferees took note of the arguments that the Senate provision "discriminated against foreign-owned U.S. corporations." [43] The statute as amended by the conference would restrict the use of losses in the United States when those losses are "shared with foreign corporations whose earnings will be subject to U.S. tax (which are typically U.S.-controlled) and not only to losses shared with foreign corporations whose earnings are never subject to U.S. tax (which are typically foreign-controlled)." [44]

The 1986 legislative materials presumably make the best case that Congress (or staff) could imagine against DRCs, the archetype of international tax arbitrage. But at the end of the day, what was that case? On a political level, the intent of Congress was plain. It had received complaints that foreign persons enjoyed an unfair advantage because some of those persons, from the United

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Kingdom and Australia, could use DRCs to gain tax benefits for a single loss in more than one taxing jurisdiction. These benefits gave those persons an economic advantage in bidding for U.S. businesses. To this concern the conferees added a "fairness" or "nondiscrimination" concern that resulted in extension of the provision to U.S. controlled dual residents. [45]

Lost in the debate were two questions that seemed reasonably important at the time and that have grown considerably in importance in the ensuing 12 years: (1) Are DRCs relevantly different from other techniques for taking advantage of differing tax rules in different countries? (2) What tax policy justifies the elimination of otherwise available U.S. tax benefits for the sole reason that the person claiming such benefits (or an economically related person) also enjoys benefits, tax or otherwise, in another country?

***148** These are questions for which the drafters of § 1503(d) had little patience. With the perspective provided by Notice 98-11 and other celebrated instances of international tax arbitrage, [46] a fresh attempt at answers seems worth the effort.

A. DRCs Are Different Because . . .

The DRC represents a clear-cut example of deliberate, direct, transactional arbitrage. A duplication of tax benefits is obtained through the intentional use of a corporation organized in the United States and therefore resident in the United States for U.S. tax purposes but managed and controlled in another country and therefore resident in that country under its tax law. Through borrowings or otherwise, the corporation is placed in a loss position and the loss is claimed, through the consolidation and grouping rules of each country, as an offset to positive income in each country. There is nothing diffuse, indirect, or accidental about this planning, which generally is undertaken for a specific purpose such as the acquisition of a U.S. business. From the U.S. point of view, the planning produces a U.S. deduction that may be used to reduce the tax on purely U.S. income of related corporations, while also producing a parallel deduction in the United Kingdom (or Australia).

Legislation targeting such planning for the sake of competitiveness is, however, unusual. Although competition with U.S. persons is a routine consideration in the formulation of U.S. tax policy with respect to foreign persons, the focus is normally on the effect of U.S. rules. That is, we ask whether the manner in which we assert taxing jurisdiction over foreign persons provides an undue advantage or is unjustifiably injurious by comparison with the rules we apply to U.S. persons. We generally do not inquire whether the foreign person is receiving a benefit, tax or otherwise, outside the United States by virtue of, or simultaneously with, the structure or actions that that person has implemented in the United States.

One reason we generally do not engage in that inquiry is the problem of drawing lines. It is difficult to say which benefits in foreign countries are relevant. Advertently or not, the United Kingdom or Australia could adopt rules having indirectly the same effect as the grouping rules that allow losses of a DRC to be used against the taxable income of related entities. They could provide a tax credit or cash subsidy to the group for investments by a group company in a foreign country, or in the United States specifically, or in a particular industry. Or, by not imposing tax on the income of controlled foreign affiliates, ***149** they could facilitate a similar result by allowing their resident companies to borrow and deduct interest on the borrowing, use the borrowed funds to create an affiliate in a tax haven, and have that affiliate finance a U.S. acquisition with a loan giving rise to deductible interest in the United States. The effect in each case would be a dual benefit for the group, though not necessarily a parallel and direct benefit in the sense of a benefit triggered in the same terms, and at the same time, by a single occurence recognized in both jurisdictions (such as accrual of interest expense). In other words, there may not be any obvious and direct "correspondence" between the foreign benefit and the U.S. benefit. For all we know, however, at any given point in time, dual benefits of the nature described exist in the tax systems of the United Kingdom or Australia, or other nations whose tax systems come into play once the debate proceeds beyond the DRC to other instances of arbitrage.

If competition is the crucial consideration but analysis proceeds beyond specific transactions, the concept of "dual benefits" is even more slippery. If Japan was to reduce its corporate tax rate to 20%, surely a Japanese automobile manufacturer who sells vehicles to a U.S. subsidiary would receive an important tax benefit. Furthermore, the benefit received in Japan undoubtedly would be of value to the entire economic enterprise, and might be enjoyed, albeit indirectly, across entity lines within the corporate group. (The loss generated by the DRC, after all, produces benefits not for the dual resident itself but for other members of the group.) Surely it would become easier for the group, through the U.S. affiliate, to do business and compete in the United

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States. Alternatively, there may be a foreign benefit in practice that is not derived from legal rules. Indulgent tax administration in the country of residence is probably beneficial, as a raw economic matter, to persons having such residence. Conceivably, the resulting economic benefits may make it easier for those persons to engage in competition with U.S. persons on U.S. soil.

B. The Problem Transcends Line Drawing

It is not a full or satisfactory response to the types of cases identified above that it may be relatively simple to identify the "duplication" of benefits in the case of a DRC. That response does not explain why the identified cases are different in substance from DRCs, or why, on policy grounds, any of these situations should result in a reduction or elimination of U.S. tax benefits--why the United States should even consider altering the available U.S. interest deduction because Japan has lowered its corporate tax rate or Canada (for example) has adopted particularly beneficial rules for foreign investment by ***150** Canadian insurance companies. These cases merely involve taxpayers taking advantage of the national tax laws of different nations. It seems appropriate to link the denial of U.S. tax benefits to benefits available under the laws of other countries only if we conclude that the United States has a policy interest that tax be imposed by those countries at some minimum level on income not subject to U.S. taxation. What is that policy interest? The direct correspondence--parallelism--of benefits in some cases but not others may come into play as a way of easing administration only after a reason for concern in the most administrable of situations has been identified.

The DRC is surely an administrable case (although the absence of an intelligible purpose for § 1503(d) has made the development of interpretive regulations an exceptionally complex task). And it may be noted that the combination of benefits was unforeseen--apparently not intended--by any single country, and the taxpayer would not have engaged in the planning but for the availability of duplicate tax benefits. In all probability, neither the United Kingdom nor Australia adopted residence and grouping rules with the intention that taxpayers take advantage of the juxtaposition of these rules with those of the United States to obtain benefits in both countries. It doubtless can be stipulated, moreover, that most taxpayers would not have engaged in the formation and use of DRCs if benefits were limited to one country. Still, from the standpoint of any one country, including the United States, it is not clear what, if anything, flows from these observations. The taxpayer obviously has engaged in tax planning. But that, by itself, is not normally cause for a loss of tax benefits, as long as the result is a real transaction in which substance and form coincide. As noted above, country rules regarding taxation inevitably will differ in many respects, and the well-advised taxpayer will pay attention to, and seek to derive advantage from, the differences.[47] It is hard to see why such fully anticipated behavior of the taxpayer should be the target of legislative pique in any country.

If there is any justification for this pique, it must lie in the area of competitiveness--specifically, the relationship between the combination of benefits achieved through arbitrage and the solitary (U.S.) benefit available to the U.S. person who is unable to put itself in a position to take advantage of arbitrage possibilities. This is the rationale that the Senate Finance Committee invoked in 1986, and perhaps this is the policy underpinning of the "international tax system" to which the Committee referred.[48] But consider the point in stark terms: It implies that the United States would have an interest in the ***151** level of French tax on French income of a French resident assuming that the French resident was also, or became, a U.S. taxpayer, or, perhaps, invested in a U.S. taxpayer. Line-drawing concerns might dictate that the policy not be pursued in all conceivable situations, but line-drawing concerns are conceptually independent of the policy itself.

An attempt to "level the playing field" by mandating that foreign persons directly or indirectly entering the U.S. tax system must pay tax at some acceptable level on non-U.S. income is inconsistent with the practical nature of taxation. Certainly there are better and worse tax systems. But the overriding justification of taxation is that it represents a way for government to fund itself on a periodic basis. There is no time for perfection, only for improvement. And there is no clear reason to seek through the tax system an ideal of egalitarianism not pursued in other aspects of national life. In setting public utility rates, we do not take into account the charge for similar services in Germany, even with respect to persons who also happen to be U.S. customers. Why, then, in establishing U.S. tax rules for those persons should we be concerned about the rate of tax they are called upon to pay on rental income in Berlin?

We do not seek to advance any such interest in a purely domestic context. U.S. persons derive varying benefits under various state and city tax laws; yet there is no equalization attempted at the federal level. Although taxation is generally higher among foreign taxing jurisdictions than at the state and local level, the difference in taxation between, say, California and Texas is not

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insubstantial. Yet, there has never been any hint of attempting to achieve equality of competitive opportunity by limiting or withholding otherwise available federal benefits to reflect benefits made available by the states and municipalities.

Furthermore, competitiveness as an explanation of policy clearly applies only to the inbound situation, when foreign persons enter into U.S. taxing jurisdiction. The extension of that policy to U.S. persons is, independently, questionable. Congress based that extension on the notion that the foreign-owned U.S. corporation denied a deduction for losses incurred by a DRC stands in the same position as a U.S.-owned U.S. corporation claiming a similar deduction. In both cases, the DRC scheme gives rise to a deduction under the rules of a foreign country simultaneously with the U.S. deduction. But are the two cases really similar? The United States has never viewed U.S. persons taxable on a net basis on worldwide income as similar to foreign persons subject to only limited U.S. taxing jurisdiction. For this reason, treaty nondiscrimination rules do not operate with respect to foreign ***152** residents, as a general matter. [49] The only exceptions are with respect to the deductibility of payments to such persons by U.S. taxpayers, the treatment of U.S. permanent establishments of such persons, and the taxation of U.S. corporations owned by such persons. [50] These limited rules should not force the United States, once it determines to deny U.S. tax benefits to foreign-owned taxpayers enjoying foreign benefits on foreign income or activities, to apply a similar rule to U.S.-owned taxpayers enjoying comparable foreign benefits but subject to an entirely different U.S. tax regime. The fact that the income of foreign entities under U.S. ownership is ultimately subject to U.S. taxation is a better response to charges of discrimination than the United States has offered in other contexts, [51] and it should be sufficient to differentiate these entities from foreign-owned foreign entities and, therefore, place them beyond the purview of treaty nondiscrimination rules. [52]

The counter-argument would have to be that deferral is a misnomer, that if the income of foreign entities owned by U.S. persons escapes current taxation under U.S. anti-abuse rules, it is effectively exempt from U.S. taxation. [53] It is hard to believe that anyone in a responsible tax policy position in the United States would be willing to advance that point of view.

For these reasons, competitiveness and nondiscrimination represent shaky foundations for the assault on DRCs, much less for a more general attack on international tax arbitrage. And deliberate international duplication of tax benefits not foreseen by any one country plainly extends beyond DRCs. The main point at issue, in the case of such companies, is the rule for determining an entity's residence: The United States looks to place of incorporation, while the United Kingdom and Australia look to place of management and control. If there is any cause for objection here, it should apply as well to double and ***153** triple dip leases, where the focus is on defining ownership, and to cases where an instrument treated as stock in one country constitutes debt in another. As noted previously, the field of arbitrage and arbitrage possibilities not anticipated by any country is large indeed.

Moreover, if arbitrage is objectionable from the standpoint of tax policy, the international application of the check-the-box regime [54] also must be questioned. Arbitrage stems from differences in the way countries approach the myriad elements that comprise a tax system. Whenever any country adopts a rule that is either difficult to replicate or apply (for example, the U.S. rules for distinguishing debt from equity) or markedly out of step with what other countries do or are likely to do, a breeding ground for arbitrage is created. [55] Whatever the justification for check-the-box as a matter of U.S. tax policy--a justification primarily based on administrability concerns [56] --the regime is clearly idiosyncratic as an international matter and thus lends itself to the same type of planning to take advantage of country differences against which the DRC legislation was directed. Furthermore, because the check-the-box regime is so easy for taxpayers to use, the invitation to arbitrage is especially compelling. [57] Thus, when the United States determined that the status of a business entity as a corporation or partnership would be determined by the taxpayer's unilateral choice, and not by objectively verifiable entity attributes, it was contributing directly to the expansion of arbitrage opportunities. Yet, Treasury adopted check-the-box, and Congress has not voiced any serious criticism. [58]

***154** Of course, Congress is not obliged to legislate with respect to all aspects of a potential target just because it finds one repugnant. The DRC scheme was brought to congressional attention in 1986, and the legislators reacted to the scheme as it was presented to them. [59] Arguably, they were not required to cast around for other comparable situations. It seems, however, that a minimum level of rational behavior is desirable even in tax matters--that some explicable line should exist between circumstances singled out for legislative action and those left for another day, particularly when the same ends may be served by both sets of circumstances. This is not an instance of the state trooper allowing one speeding vehicle to pass without challenge

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while arresting the next one. The trooper here has stopped one vehicle while actively encouraging other speeding vehicles to go faster.

It is possible, for all the foregoing reasons, to be skeptical regarding the need to address the subject of international tax arbitrage as a general matter. The task of identifying elements in another country's tax system that are a sufficient source of concern for otherwise available U.S. tax benefits to be limited or denied is difficult, time-consuming, and endless: It is hard to distinguish one form of arbitrage from another, to distinguish arbitrage in general from other tax minimization strategies, to distinguish tax benefits from other benefits that may be enjoyed outside the United States by persons related to the U.S. taxpayer. Moreover, the reasons for concern are murky; it seems justifiable only on the basis of a mysterious "international tax system" in which U.S. benefits are withdrawn, on general competitiveness and nondiscrimination grounds, by reason of benefits enjoyed in other jurisdictions with respect to tax (or other) rules having nothing to do with the United States. The attributes of deliberateness, parallelism, elegance, and lack of foreseeability by any one country do not add up to a tax policy.

The objection to addressing international tax arbitrage is not merely limited to the difficulty of doing so in a rational and feasible way. The broader objection is that there does not appear to be any clear reason why U.S. tax policy should take account of the fact that the taxpayer or a related party enjoys benefits under the tax laws of another country with respect to income or activities not subject to U.S. taxation. The treatment of that income or those activities is not obviously our business, and there is no clear reason why we should make it our business--any more than the rules of that other country applicable to its ***155** own citizens and residents on its own soil with respect to anticompetitive behavior, corrupt practices, or the price of water.

Contrary to the 1986 Finance Committee Report,[60] the foreign tax credit is a different matter. The credit reflects a U.S. commitment to reduce or eliminate international double taxation with a goal of facilitating (or removing obstacles to) U.S. enterprise outside U.S. borders. The commitment is limited to income taxes and taxes in lieu of income taxes, and some attempt to categorize foreign imposts in light of these standards is therefore necessary. The credit requires a narrow inquiry with a specific, easily defined (if not always easily applied) purpose. The foreign system is taken as we find it and categorized in U.S. terms.[61] Arbitrage is different. The search here is for a benefit enjoyed outside the United States. Broadened in a rational way, the DRC approach would link denial of U.S. benefits to the existence of elements in a foreign country's tax or legal system that allow for independent benefits of a specified nature. Whether those elements would be narrow and limited, and corresponding in some sense to otherwise available U.S. benefits, or broader and more diverse, is itself a policy choice of major proportions. In either event, the inquiry would be into the legal operation and practical effect of the foreign system with respect to income or activities not subject to U.S. tax jurisdiction. There is common ground between such an inquiry and the one envisioned by the foreign tax credit rules only insofar as they both involve scrutiny of a foreign tax system.

One lesson from the evolution of the Code is that logic can be overvalued. It was, after all, rigorous logic that produced the foreign tax credit limitation of §§ 904(b) and (d). Nevertheless, it is perplexing to have laws in which DRCs come in for strict scrutiny while Treasury and the Service actively facilitate other transactions in which arbitrage benefits may be claimed. As matters stand today, U.S. tax laws attack DRCs, tolerate double dip leases, encourage arbitrage with respect to entities, and provide that even stock is to be treated in specified circumstances as debt.[62] The aberrant element here seems to be § 1503(d), a statute that the legislative history does little to justify. The congressional references to "competition" from foreign owned ***156** companies are not satisfying, and the application of the legislation to U.S. controlled companies in order to avoid "discrimination" is unpersuasive. In the absence of some compelling (but heretofore unexpressed) policy reason favoring § 1503(d) and similar statutes aimed at schemes similar to DRCs, it is hard to see why international tax arbitrage should be a source of general U.S. tax policy concern.

IV. Ah, Yes! But Is There a Specific Problem?

There is a demonstrable U.S. interest in international tax arbitrage, but it is limited in scope. A specific, identifiable U.S. tax policy issue deserving of attention exists because, in various sections of the Code, the United States has surrendered to the temptation of using foreign taxation as a means of pursuing U.S. tax policy concerns. This technique seems questionable because it places the United States on both sides of the basic question whether any particular level of foreign tax should be encouraged.

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As noted below, there are various economic reasons for the United States to adopt a hands-off position on whether and when foreign countries should tax, and at what level.

One example of the cited technique is § 865 under which the source of certain income from personal property sales turns in part on the existence of a minimum foreign tax. [63] Another example, more extensive in application, is the series of provisions that look to the actual or presumed application of foreign tax rules as a means of implementing subpart F. [64] In each case, foreign taxation is regarded as evidence of the bona fides of a foreign presence. [65] It allows the United States to conclude that the person or entity in question has justified its situation abroad, which situation produces U.S. benefits in the nature of deferral and foreign sourcing (nontaxation) of certain income. In such circumstances we have deliberately made foreign taxation into a U.S. tax issue. [66]

***157** In light of the explosion of criticism caused by Notice 98-11 [67] and only partially put to rest by Notice 98-35 and subsequent events, [68] the subject of deferral is especially pressing. This question obviously involves U.S.-owned foreign entities, the outbound situation in which the rationale for anti-arbitrage sentiment seems especially weak. Treasury and the Service have been severely criticized for attempting in Notice 98-11 to backstop the tax systems of other countries, thereby causing U.S. enterprises to pay a higher level of foreign tax than they otherwise would. [69] Some view this as a sharp about-face of U.S. policy, making little sense for the U.S. fisc. [70]

As a general matter, it is hard to see why it is a function of U.S. tax authorities to ensure that foreign governments collect any particular amount of tax, either generally or from U.S. companies and their affiliates. This is not a way to keep U.S. foreign tax credits to a minimum. It is not a way to encourage the foreign success of U.S. enterprise. It has corrupting effects on the "compulsory payment" rules of U.S. foreign tax credit theology. [71] Sometimes, however, and this is the nub of the problem, foreign taxation has been used as a factor in U.S. taxation, as a way of distinguishing those enterprises that have a legitimate purpose for establishing foreign affiliates from those that are simply attempting to reduce the U.S. tax burden.

The 1962 legislation that produced subpart F [72] resulted from a compromise between a Kennedy Administration proposal that deferral be eliminated and the fierce defense of the U.S. multinational community that forgoing current taxation of the income of a controlled foreign corporation (CFC) was needed in order to maintain international competitiveness of U.S. enterprise. [73] The compromise that has rested at the core of the statute ever since is that deferral is acceptable for a CFC if there is a demonstrated business need for operating abroad in foreign corporation solution. [74] Local purchase, sales, and services activities ***158** in the foreign country of incorporation satisfy this requirement in and of themselves. So do manufacturing activities. Other active business endeavors in the nature of services or licensing also may justify foreign incorporation as long as certain additional conditions are met: in the case of services, that the foreign corporation is not receiving substantial assistance from related persons; in the case of licensing, that an active business enterprise is being carried on. [75]

For many other activities and functions, those that generate passive income and those that are inherently mobile and thus presumably could have occurred in the United States, there is generally no deferral unless it can be shown that foreign taxes at a sufficient level apply to the resulting income. This is an obvious use of foreign taxation to meet U.S. tax policy concerns. It is thought that if the foreign affiliate is paying tax at a high rate, the affiliate must be serving a genuine nontax purpose. Deferral, in these circumstances, applies.

Passive income also qualifies for deferral if it is earned by a CFC incorporated under the laws of the same country as the payor of the income, and if the payment does not (as a U.S. matter) reduce income that otherwise would be disqualified for deferral and taxable currently in the United States. [76] The assumptions underlying this rule seem to be that residence of the foreign entity is determined for foreign purposes according to place of incorporation, that is, in the same way as in the United States, and that it does not matter if the foreign country collects its residence-basis tax from two entities rather than one. The United States says, in effect, that operating through two entities should not diminish or eliminate an opportunity for deferral that a single entity otherwise would have.

Another use of foreign taxation in the implementation of subpart F relates to the foreign base company sales rules. If a CFC operates through a branch or similar establishment in a country other than the country of incorporation, and the effect is as if the branch were a wholly owned subsidiary of the CFC, the branch will be considered a separate subsidiary corporation for purposes of those rules. [77] The statutorily described effect is found if taxes on the branch are below a designated percentage of the taxes that would have applied in the country of incorporation. [78] Again, the statute (as interpreted by regulations) ***159** looks to the level of foreign tax to determine whether the "branch rule," and therefore potential current U.S. taxation, will apply. [79]

International tax arbitrage is relevant to this statutory and regulatory scheme because it can allow taxpayers to reduce the foreign tax burden in the country where a CFC is incorporated without disturbing qualification for deferral under other statutory justifications for a foreign presence. To the extent U.S. law depends directly on the level of foreign taxation, the reduction accomplished by arbitrage automatically is taken into account by the U.S. rules. The level of foreign taxation, however, is only one of the statutory justifications for a foreign affiliate, and the effects of arbitrage are not necessarily inconsistent with the others. As Notice 98-11 observes, a payment of interest from a CFC to an entity that the foreign country of incorporation regards as separate (and resident in another country) but the United States treats as a branch of the payor and thus nonexistent for tax purposes may reduce tax in the country of incorporation and yet not be subject to tax in the United States. [80] This circumstance arguably evokes the same kind of policy concerns that led Congress in 1962 to provide the branch rule for foreign base company sales income. [81] Alternatively, a payment of interest or dividends may be viewed by the country of incorporation as a payment to a third country and yet be regarded by the United States as a same country payment if the United States sees the recipient as a branch of a second corporation incorporated in the same country as the payor.

The branch rule was a late addition to the original subpart F statute and limited in scope. Moreover, the statute was enacted long before the current fashion of legislating rough drafts and leaving the heavy technical lifting to Treasury and Service regulation writers. There is only limited scope for policy-oriented embroidery here. [82] Thus, the effort to extend the branch rule from its origins in the universe of foreign base company sales income to deemed payments of foreign personal holding company income appears quixotic under current law.

***160** The deeper question, of course, is whether the United States should be concerned, and this, in turn, depends upon how one is to view the 1962 compromise today, either as a historical matter or as a topic of current tax policy. Insofar as the historical question is concerned, one approach is to probe the U.S. attitude toward the subsequent use of income that qualifies, when earned, for deferral.

Congress gave an answer of sorts to this question when it first enacted and then repealed § 956A, relating to excess passive assets. [83] It thus conveyed the message that the 1962 compromise favored deferral, not its opposite, that current taxation of the income of CFCs was the exception to a general rule, and that income once deferred may remain deferred indefinitely. On this view, subpart F expresses concern not about any long-term advantage to the investment of capital abroad in foreign corporate solution but, much less comprehensively, about whether particular items of income might not just as well have been earned by a U.S. person. If this is a correct interpretation of subpart F, the United States has no general policy interest in any particular level of foreign tax, but only in the question whether an acceptable justification for deferral (which can derive from the level of foreign tax but need not) has been established. In fact, it is probably in the national interest for the foreign tax burden on affiliates of U.S. companies that are legitimately incorporated and earning income abroad to be lower rather than higher. If a CFC engaged in manufacturing activities pays "interest" to what Notice 98-11 refers to as a "hybrid branch," an entity recognized in the foreign country of incorporation but whose existence is denied by the United States, [84] the net effect is to reduce the foreign tax rate on manufacturing activities, from a U.S. viewpoint. Since manufacturing qualifies for deferral perse, and since both the rate of foreign tax and the use of the deferred income are irrelevant to that qualification, there is arguably no U.S. tax policy interest here. [85]

***161** The 1962 compromise seems to have regarded manufacturing income as qualifying for deferral not because of any expressed assumption that manufacturing would be undertaken only in high-tax foreign countries (there is no hint of such an assumption in the statute or legislative history) but because an activity as solid and "real" as manufacturing was less mobile than many other activities, required a capital investment, and arguably could be viewed as necessitating (or at least explaining)

a foreign incorporated presence. There are some questionable assumptions in this chain of reasoning, but it is not clear that any of them turned, in 1962, on the effective rate of foreign tax. The thought was that a taxpayer prepared to engage abroad in something as substantial as manufacturing is entitled to do so through a foreign entity.

If this view is accepted today, there is no reason for the United States to object to any legitimate means of reducing the foreign tax burden on manufacturing activities. True, the hybrid branch removes income, on a tax-deductible basis, from the country of incorporation, but if the United States does not care in the first place how high the foreign tax is and has chosen not to concern itself with the disposition of deferred income, except insofar as that income generates further income not qualifying in its own right for deferral (or is repatriated to the United States and becomes subject to tax as an investment in U.S. property), it is difficult to articulate the U.S. objection to the hybrid branch. The technique potentially would allow all foreign manufacturing to bear a low rate of foreign tax, but is that clearly an undesirable result? The lower effective rate of tax could draw some manufacturing activities, the most mobile, from within the United States, but the 1962 compromise envisioned (or at least tolerated) that result in the case of manufacturing in low-tax foreign jurisdictions and the fact that hybrid branches are capable of converting all jurisdictions into low-tax jurisdictions does not clearly undermine what is, in effect, one of the bedrock aspects of the 1962 compromise. On this view, the hybrid branch merely represents a creative use of the tax laws of the foreign country of incorporation.

Nor is the analysis any different if some or all of the income of the CFC is subject to current U.S. taxation under subpart F. The hybrid branch still has the effect of reducing the effective foreign tax rate. Either this results in a concomitant loss of the justification for deferral (because the foreign tax is no longer sufficiently high to furnish such a justification) or a lesser foreign tax credit on income taxable under § 951. In either event, it is difficult to identify a U.S. tax policy concern.

***162** It is possible that the foreign country of incorporation could view the hybrid branch technique as an aggressive U.S. scheme for depleting its tax base, and this could lead to ill feelings or even retaliation. But why should these consequences ensue? The taxpayer is merely claiming a legitimate interest deduction under the laws of that country. Moreover, the foreign country is not powerless in these circumstances. Engaging in the same analysis the United States employed in regard to DRCs, it could choose, if it so desired, to deny interest deductions because of the U.S. treatment of hybrid branches. This would be a fairly extreme position, however, since the effect of the hybrid branch is to achieve an interest deduction in the foreign country while the United States merely ignores what that country sees as the corresponding interest income. It would be strange (but perhaps no stranger than the U.S. analysis with respect to DRCs) for the country of incorporation to limit or eliminate its interest deduction just because the anti-abuse rule of subpart F does not apply to the income it perceives, since there are many countries that do not have a regime like subpart F at all. The country of incorporation may not grasp all the subtleties of the U.S. check-the-box rules, but it is hardly clear why it should wage tax war over the issue as it appears in Notice 98-11. [86]

The second situation involved in Notice 98-11, where the taxpayer invokes the "same country" justification for deferral with respect to interest or dividend income that crosses from one entity to another, is a different matter. This is not a case involving a reduction in foreign tax without a corresponding U.S. income inclusion on the ground that the United States sees no income under its rules. Rather, U.S. rules and those of the country where the payor is incorporated both see income, but they differ on the question of whose income it is. The United States views the hybrid branch as part of a corporation incorporated under the laws of the same foreign country as the payor. That country perceives the recipient as a third-country entity. The third country either does not tax or taxes at a low rate. Presumably, if interest is involved, the income of the payor qualifies for deferral as income from manufacturing or on some other basis since the same country justification for deferring tax on interest income does not apply if the interest reduces subpart F income.

In this situation, the hybrid branch is used to undermine the "same country" justification for deferral because it produces a same country ***163** payment for U.S. purposes but not for those of the foreign country of incorporation. There are good reasons for U.S. concern here, since the same country justification is based upon assumptions regarding the tax system of the country of incorporation. These assumptions are not always correct even without regard to the use of hybrid branches (many countries do not link residence to place of incorporation), [87] but the hybrid branch technique can make them wrong all the time. The remedy might be to interpret the same country justification in terms of its original understanding--that the United States generally should be indifferent whether a taxpayer is operating in a single foreign country through two, rather than one, CFCs taxable on a residence basis. In that event, if the foreign country did not regard the hybrid branch as a resident taxable entity,

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the justification for deferral would not be available. To the extent the ossified statutory scheme does not permit such a policy-oriented interpretation, the United States surely has a strong interest in ensuring that hybrid branches do not permit the use of the same country justification in circumstances where its underlying rationale does not apply.

Since subpart F operates on the basis of evidentiary showings of a need to be abroad, and the foreign tax level has been relied on in these showings, it is possible to view the different uses of international tax arbitrage in this context in different ways. A justification based on a same country interest or dividend payment that the foreign country of incorporation does not perceive as a same country payment seems different from interest paid by a CFC that the foreign country of incorporation recognizes as deductible but whose existence the United States does not acknowledge. In the latter case, the payment merely serves to reduce the level of foreign tax, which may or may not be important for purposes of subpart F. In the former case, the arbitrage results in a perversion of the justification for deferral. This is because the same country justification rests, ultimately, upon the taxation rules of the country of incorporation, as opposed to the definitions and rules, including check-the-box rules, of the United States.

V. Remedies, Remedies

If, despite the skepticism expressed above, there does (or might, or should, or could) exist an "international tax system" calling for broad harmonization among nations and condemning, at least to some extent, international tax arbitrage and its uses, where would one find it? ***164** No careful search or analysis is required for the conclusion that there is as yet no formal multilateral document that embodies such a system.[88] Nor, in fact, are there encouraging pronouncements from national tax regimes to demonstrate that the system is a matter of common understanding.

One place to look, presumably, is the network of international tax conventions that indisputably does exist and that represents, cumulatively, a triumph of international law in the field of taxation. One important U.S. contribution to this formidable body of law is the addition to the title of the U.S. Model Income Tax Convention of a purpose "for . . . the prevention of fiscal evasion."[89] Could it be that this phrase and all that flows from it give evidence of the international tax system that the Finance Committee invoked in 1986?

The difficulty with this hypothesis is that international tax conventions themselves usually make clear that they are elective: "The Convention shall not restrict in any manner any benefit now or hereafter accorded . . . by the laws of either Contracting State," in the words of the U.S. Model Treaty.[90] This means, simply, that a taxpayer may reject a treaty and its contents and invoke instead its rights under domestic law, both in the United States and in the other country. Since international tax arbitrage generally (though perhaps not invariably) builds upon differences in domestic laws, not treaties, an election to rely on domestic law would leave the taxpayer with the same arbitrage opportunities as if the treaty did not exist at all. In other words, the treaties lack the leverage to implement an international tax system by striking at international tax arbitrage. The reference to fiscal evasion in the title of the U.S. Model Treaty refers not to some invisible set of transnational provisions but to the domestic laws of the treaty partners; the treaty is supposed to provide means for preventing taxpayers from evading such laws, and it accomplishes that task primarily through its provisions calling for exchange of tax information and the detailed rules governing the procedures and timing of that exchange. ***165** This, of course, leaves the convention's title with a clear meaning but, since arbitrage by definition does not involve evasion of the laws of any country, this meaning is distinct from any international tax system that would pertain to arbitrage.

The only remaining place in which the supposed international tax system could be found is the domestic laws of nations--in the United States, the Code. The comments offered previously suggest that the policy basis for rules targeting arbitrage seems insubstantial at best, and the line-drawing exercise appears daunting. Nevertheless, it is conceivable that Congress could strike a blow in favor of its international tax system by enacting appropriate legislation.

Section 1503(d) does not qualify as appropriate legislation. It is too narrow and specific in scope, and any conceivable goal of the section is too easily achieved by other means outside the rules that have been enacted, and interpreted, to date. If § 1503(d) is a correct reflection of a proper general purpose, the statute must be enlarged so that its prohibition of U.S. tax benefits applies in comparable arbitrage situations. And since there are many such situations, with new ones emerging on a regular basis, the enlargement arguably should be open-ended--with Treasury and the Service accorded discretion to define, by regulation or

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otherwise, those situations that run afoul of the policy course that Congress articulates. The alternative would be a long list of specific cases of arbitrage and jeopardized U.S. tax benefits, supplemented from time to time as new situations come to the attention of Congress.

Needless to say, there would be huge problems with either approach. It already has been suggested how any policy concerns that could underlie the DRC provisions extend broadly into other areas, tax and nontax. In these circumstances, line-drawing will border on the impossible, and proscribed arbitrage plays will make up a lengthy list. On the other hand, a statute according wide-ranging power to the Service to withdraw otherwise available U.S. tax benefits is certain to be viewed with horror by U.S. taxpayers and, presumably, by Congress.

What to do? A starting point might be for Congress to attempt once again to answer the underlying questions, raised but admittedly not disposed of in this essay, of whether we care about arbitrage and why. The exercise might enable tax policymakers either to press beyond DRCs into other specific areas or to make a thoughtful, and forthright, retreat. The shape of a sensible statutory provision in this area is not going to become clear unless and until there has been an intelligent explanation of purpose.

*166 VI. Conclusion

International tax arbitrage, the deliberate exploitation of differences in national tax systems, is the planning focus of the future. This is not a passing fad, not a minor phenomenon. Thanks in large part to the tutelage of U.S. professionals, taxpayers throughout the world have become conscious of the many benefits of threading a course among domestic tax laws.

The question this essay asks is: So what? The policy response the United States has offered so far calls to mind a deer caught in headlights. If we have a legitimate concern about benefits obtained by taxpayers on income or activities not subject to U.S. jurisdiction, we should endeavor to explain coherently what that interest is. Invoking the international tax system does not constitute an explanation, since that system appears to be imaginary. Whether it would be desirable is a different question--but one bearing only marginally on the intensely practical world of international tax policy.

Footnotes

a1 Member, Caplin & Drysdale, Chartered, Washington, DC. The David Tillinghast Lecture was delivered at NYU School of Law on October 1, 1998.

1 S. Rep. No. 99-313, at 422 (1986).

2 See Joseph Isenbergh, International Taxation: U.S. Taxation of Foreign Persons and Foreign Income, at xcix (2d ed. 1998) (“In a strict sense there is no international taxation. All taxes great and small are creatures of purely national tax laws.”).

3 Reg. § 1.901-2(a)(2).

4 Only non-Saudis are subject to the Saudi Arabian income tax, while Saudis pay the Zakat, a separate religious levy. [Saudi Arabia] Tax Laws of the World 1, 52-54 (1993). Is this arbitrary?

5 [Ger.] Tax Laws of the World 120 (1993); see IRC § 904(d).

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6 DeBeers Consol. Mines Ltd. v. Howe, 93 T.L.R. 63 (K.B. 1905); see Finance Act 1988, § 66 & Explanatory Note. Compare IRC § 7701(a)(4).

7 Compare IRC §§ 641-679.

8 See Reg. § 301.7701-2, -3.

9 See IRC §§ 11(a), (d); 7701(a)(4), (5).

10 See, e.g., Laidlaw, Transp., Inc. v. Commissioner, 75 T.C.M. (CCH) 2598 (1998).

11 IRC § 7701(a)(4).

12 IRC § 861(a)(4).

13 See, e.g., Laidlaw, 75 T.C.M. (CCH) 2598, and decisions cited therein.

14 See Charles I. Kingson, Taxing the Future, 51 Tax L.Rev. 641 (1996) (David R. Tillinghast Lecture).

15 To all of the above should be added the limitations of language to describe all the potential variations of human action and inaction that the Code aims to cover. See generally Gustave Flaubert, Bouvard et Pécuchet (1880).

16 Pub. L. No. 99-514, 100 Stat. 2085.

17 IRC § 11(a).

18 IRC §§ 951-964.

19 IRC § 482.

20 IRC § 904.

21 See, e.g., SDI Netherlands B.V. v. Commissioner, 107 T.C. 161 (1996).

22 See, e.g., Prop. Reg. § 1,7701(l)-3; Notice 97-21, 1997-1 C.B. 407 (involving step-down preferred stock).

23 See, e.g., ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189 (1997), aff'd in substance, 157 F.3d 231 (3d Cir. 1998) (invoking substance-over-form doctrine to deny losses from transactions for which no nontax business purpose was found).

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24 See, e.g., Laidlaw Transp., Inc. v. Commissioner, 75 T.C.M. (CCH) 2598 (1998).

25 The term "arbitrage" can be used in the broader and more general sense of any item that gives rise to a deduction in one jurisdiction while the recipient in another jurisdiction is not found to have income. This usage underscores the vagueness of the arbitrage concept. In this essay, the term is generally used in the narrower sense.

26 Ltr. Rul. 9748005 (Aug.19, 1997).

27 See, e.g., Nebraska Dept. of Revenue v. Loewenstein, 513 U.S. 123 (1994); American Nat'l Bk. of Austin v. United States, 421 F.2d 442 (5th Cir. 1970), cert. denied, 400 U.S. 819 (1970); Rev. Rul. 74-27, 1974-1 C.B. 24. The cited authorities involve repurchase agreements or "repos," but substantially similar results have been achieved through securities loans and "usufructs."

28 See, e.g., Plantation Patterns, Inc. v. Commissioner, 29 T.C.M. (CCH) 817 (1970).

29 See, e.g., Coleman v. Commissioner, 87 T.C. 178 (1986), aff'd, 833 F.2d 303 (3d Cir. 1987); see also Field Service Advice 199934009 (1999).

30 There is, of course, no reason why the effort need involve the United States at all. Like so many other tax ideas that we have exported over the years, tax arbitrage can be put to use by foreign persons having no immediate or likely future U.S. tax involvement.

31 Consider, for example, this observation in Ltr. Rul. 9835011 (May26, 1998), in which a cash dividend was recontributed to the capital of a foreign subsidiary pursuant to a preconceived plan: "Although the transaction is designed to achieve inconsistent tax characterizations under the income tax laws of the United States and the income tax laws of CountryX, the intended results of the transaction are not inconsistent with the purposes of U.S. federal income tax law (including the bilateral income tax treaty with CountryX)."

32 See Notice 98-5, 1998-3 I.R.B. 49.

33 It is also possible to string together various arbitrage elements, so that, for example, one country perceives in a given structure stock issued by entityX owned by entityA generating foreign tax credits while the other country finds debt issued by entityZ owned by entityB giving rise to interest deductions.

34 Notice 98-11, 1998-6 I.R.B. 18, withdrawn by Notice 98-35, 1998-27 I.R.B. 35.

35 Pub. L. No. 99-514 § 1249(a), 100 Stat. 2085, 2584. The ultimate action is set forth clearly in § 1503(d)(1): "The dual consolidated loss for any taxable year of any corporation shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year." The term "dual consolidated loss" means "any net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside of such foreign country, or is subject to such a tax on a residence basis."

36 S. Rep. No. 99-313, at 420 (1986).

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37 Id.

38 Id.

39 Id. at 421.

40 Id.

41 See IRC §§ 864, 884, 897.

42 Conference Report to Accompany H.R. 3838, H.R. Rep. 99-841, 99th Cong., at II-657, (1986).

43 Id. Most tax treaties contain prohibitions against discrimination in tax matters. The U.S. Model Income Tax Convention, Sept.20, 1996, art. 24(4), 1 Tax Treaties (CCH) P 214, provides that "[e]nterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected." The nondiscrimination argument would be that a limitation on deductibility of losses of a foreign-owned DRC is discrimination in the absence of any such limitation on losses of U.S.-owned dual residents. Arguably, however, the fact that income of U.S.-owned foreign affiliates is subject to U.S. tax when repatriated to the United States establishes a "dissimilarity" between the two situations. See text accompanying notes 49-53.

44 Conference Report, note 42, at II-657.

45 It also could be that esthetics played a role. One staff member observed to the author at the time that the dual resident technique belonged in the "hall of fame of tax abuse."

46 See, e.g., Notice 98-5, note 32.

47 See text accompanying notes 5-15.

48 See text accompanying note 1.

49 See, e.g., OECD, Model Tax Covention on Income and Capital (July 23, 1992), 1 Tax Treaties (CCH) P 191.

50 See, e.g., id., PP 3-5.

51 All countries routinely "discriminate" against foreign persons in tax matters, but the United States has been especially sensitive to charges of discrimination. When plainly discriminating against foreign persons, it has allowed them to elect to be taxed as domestic persons, IRC § 897(i), justified the discrimination by (dubious) comparison to tax-exempt domestic persons, IRC § 163(j), and talked itself into the conclusion that discrimination did not exist, IRC § 884(f)(1)(B), Notice 89-90, 1989-2 C.B. 394; Treas. Reg. § 1.882-4; Tech. Adv. Mem. 199941007.

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52 The nondiscrimination argument does not pertain to the DRC itself, which is entitled to its U.S. deduction under § 1503(d), irrespective of ownership. The denial effected by § 1503(d) only operates with respect to a related U.S. corporation claiming use of the deduction under the consolidated return rules.

53 The argument could draw upon experience with the DISC, which turned out to be (legally) an exemption, rather than a deferral, mechanism, years of protestation by Treasury to the contrary notwithstanding. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 805 (b)(2)(A), 98 Stat. 494, 1001.

54 Reg. §§ 301.7701-2, -3.

55 Consider, for example, the rule set forth in § 860H(c)(1), as enacted in recent legislation pertaining to financial asset securitization investment trusts: "[A] regular interest in a FASIT, if not otherwise a debt instrument, shall be treated as a debt instrument." IRC § 860H(c)(1); Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1621(a), 110 Stat. 1755, 1858-59. A clearer invitation to international arbitrage would be difficult to imagine.

56 See generally Notice 95-14, 1995-1 C.B. 297 (containing the preamble to proposed regulations).

57 As a test of how much the check-the-box rules stand at variance with § 1503(d), consider the response of U.S. tax policymakers if it were suggested that entity residence, in addition to classification, might be determined by making an election on an appropriate form.

58 See Staff of Joint Comm. on Tax'n, Review of Selected Entity Classification and Partnership Tax Issues (Apr. 8, 1997), 97 TNI 69-22, available in LEXIS, TNI File. Check-the-box is only the most significant example of tax policy pronouncements that cannot be reconciled with general hostility to tax arbitrage. The Service has been cheerfully supportive of double dip leases notwithstanding the compelling similarity of such arrangements to dual resident companies and the Tax Court's decision (apparently widely disregarded) in Coleman v. Commissioner, 87 T.C. 178 (1986). See Ltr. Rul. 9748005 (Aug.19, 1997). But see Field Service Advice 199934009 (1999), where the Service, relying in significant part on Coleman, suggests that arbitrage calls into question the "substance" of a transaction or characterization. This approach is not likely to be very useful where countries take a different view of what the tax-controlling substance is.

59 Thus, the legislation is directed only at losses, because losses were on the minds of the lobbyists that prodded Congress to act. It is axiomatic in international tax matters that credits and losses behave in much the same fashion.

60 See text accompanying note 40.

61 The "dual capacity taxpayer" rules of Reg. § 1.901-2A are an exception, adopted largely on political grounds, to the general statement in text. They envision a U.S. reformulation of the foreign tax system. To similar effect is the treatment of the Italian regional tax on productive activities in the new income tax convention between the United States and Italy. Convention for the Avoidance of Double Taxation, Aug. 25, 1999, U.S.-It., art. 23, 2 Tax Treaties (CCH) P 4801.23.

62 IRC § 860H(c) (stating that "regular interests" in a FASIT will be treated as debt irrespective of their form, which may be stock for other purposes).

63 IRC §§ 865(e)(1)(B), 865(g)(2).

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64 E.g., IRC § 954(b)(4).

65 See also Second Protocol to Income Tax Convention, U.S.-Neth. Oct. 23, 1963, art. I, 3 Tax Treaties (CCH) P 6,239.

66 The point is different from the one underlying the recently issued § 894 regulations and enactment shortly thereafter of a statutory amendment to § 894. Reg. § 1.894-IT; IRC § 894(c). These authorities would have U.S. benefits under tax treaties turn upon the tax treatment applied by the treaty partner. This, of course, represents an example of arbitrage in the broader sense defined in note25. Moreover, the question here is whether entitlement to treaty benefits should be determined under the rules of the United States or those of the treaty partner. The bilateral nature of this question--what was the intention of the treaty negotiations and the resulting international conventions--distinguishes it clearly from the issues discussed in text.

67 Notice 98-11, note 34.

68 Notice 98-35, 1998-27 I.R.B. 35.

69 See, e.g., Paul Cherecwich, Jr., TEI Calls Hybrid Arrangements Notice "Poor Tax Policy," 98 TNT 54-34, Mar. 20, 1998, available in LEXIS, TNT File.

70 Id.

71 Reg. §§ 1.901-2(a)(2), -2(e)(5).

72 Revenue Act of 1962, Pub. L. No. 87-834, § 12, 76 Stat. 960, 1006-31.

73 See National Foreign Trade Council, The NFTC Foreign Income Tax Project: International Tax Policy for the 21st Century, ch. 2, 99 TNT 58-17, Mar. 26, 1999, available in LEXIS, Fedtax Library, TNT File.

74 The rationale for the compromise can be debated. Some view subpartF as resting on considerations of capital export neutrality, the desire to remove tax considerations from deliberations of a U.S. person determining whether to situate an investment in the United States or abroad. Notice 98-11, note 34. Others maintain that subpartF is really aimed primarily at protecting the U.S. tax base. National Foreign Trade Council, note 73, at 2-21. The two rationales are subtly different, but the essence of the compromise does not depend on deciding which of them is correct, or whether one is in any way inconsistent with the other.

75 Reg. §§ 1.954-4(b), -2(d).

76 IRC § 954(c)(3).

77 IRC § 954(d)(2).

78 Reg. § 1.954-3(b)(1)(i)(b). There has been considerable debate over the meaning of the term "branch or similar establishment." See Ashland Oil, Inc. v. Commissioner, 95 T.C. 348 (1990); Vetco, Inc. v. Commissioner, 95 T.C. 579

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(1990); Rev. Rul. 97-48, 1997-2 C.B. 89. From a policy viewpoint, there probably should be less focus on Webster's and more on the question whether there has been a meaningful reduction of residence country tax.

79 Qualification for deferral may yet be achieved on the basis of the foreign tax level, even if there is a disparity in tax rates between the country of the branch and the country of incorporation. IRC § 954 (b)(4).

80 Notice 98-11, note 34.

81 See Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960, 1009-13 (adding IRC § 954).

82 It might be argued that Treasury has exceeded what scope there is in applying the branch rule in the case of a "manufacturing branch" as opposed to the "sales branch" clearly described in the statute.

83 Pub. L. No. 103-66, § 13231(b), 107 Stat. 312, 496, repealed by Pub. L. No. 104-188, § 1501(a)(2), 110 Stat. 1755, 1825.

84 Notice 98-11, note 34.

85 In this connection, it is worth underscoring that the existing branch rule does not operate merely on the basis of a low foreign tax rate. It also must be shown that when the branch is viewed as a separate entity, either the activities of the branch or those of the remainder of the corporation give rise to foreign base company sales income. Reg. § 1.954-3(b)(1)(i)(a). Thus, a CFC that manufactures a product and uses a branch in a second foreign country as a contract manufacturer of a component qualifies for deferral irrespective of the level of tax in either country. For general discussions of the branch rule, see Leonard R. Olsen, Jr., Affirmative Use of the Branch Rule, 1Int'l Tax J. 172 (1975); Leonard R. Olsen, Jr., Working With the Branch Rule of Section954(d)(2), 27 Tax Law. 105 (1973).

86 Notice 98-11, note 34. On the other hand, that country is not without power to limit deductions, whether for interest generally, for interest payable to affiliates (domestic or foreign), or for cross-border interest. Cf. IRC § 163(j) (imposing a limitation on the deduction of interest in cases involving "earnings stripping").

87 Thus, a same country payment of dividends or interest to a company incorporated in the same country as the payor but managed and controlled in a third country, and not considered a tax resident by the country of incorporation, presents the same issue identified in Notice 98-11, note 34.

88 The work of the Organisation for Economic Co-Operation and Development on "harmful tax competition" is aimed at achieving cooperation at a much higher level of tax policy than the detailed rules that give rise to the arbitrage discussed here. See generally OECD, Harmful Tax Competition: An Emerging Global Issue (1998). It does not appear realistic that efforts of this nature could ever eliminate the type of country differences identified previously in the text, and it is not even clear that such elimination is a desirable international goal.

89 U.S. Model Treaty, note 43.

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90 Id. art. 1(2). In the United States, where the Constitution requires that revenue measures originate in the House of Representatives while the advice and consent power with respect to all conventions resides in the Senate and the House has no role in the process leading up to ratification, the elective nature of treaties arguably is constitutionally mandated.

53 TAXLR 137

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COMPAQ COMPUTER CORPORATION AND SUBSIDIARIES, Petitioner–Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent–Appellee.

No. 00–60648.

United States Court of Appeals, Fifth Circuit.

Dec. 28, 2001.

Corporate taxpayer filed petition for redetermination of deficiency that had been sent by Commissioner of Internal Revenue regarding its federal income tax obligations for prior tax year, and of accuracy-related penalty for negligence that had been assessed. The United States Tax Court, Mary Ann Cohen, Chief Judge, 1999 WL 735238, upheld deficiencies and negligence penalty. Taxpayer appealed. The Court of Appeals, Edith H. Jones, Circuit Judge, held that taxpayer's foreign stock transaction, in which it purchased American Depository Receipts (ADRs) with settlement date at time when taxpayer was entitled to a declared dividend, and immediately resold them with settlement date at which it was no longer entitled to dividend, had economic substance and a business purpose, and thus could not be disregarded for federal tax purposes.

Reversed.

1. Internal Revenue ⚿4705, 4730

Court of Appeals reviews Tax Court's conclusions of law de novo and its factual findings for clear error.

2. Internal Revenue ⚿4708

Tax Court's determinations of mixed questions of law and fact are subject to de novo review.

3. Internal Revenue ⚿4705, 4707

Legal conclusions by the Tax Court that transactions are shams in substance for income tax purposes are reviewed de novo, and this is true even though the Tax Court has characterized some of its determinations as ultimate findings of fact.

4. Internal Revenue ⚿3071

Where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

5. Internal Revenue ⚿3255, 3260, 4100

Foreign stock transaction engaged in by corporate taxpayer through purchase and resale of American Depository Receipts (ADRs), in which it purchased ADRs with settlement date at time when taxpayer was entitled to a declared dividend, and immediately resold them with settlement date on which it was no longer entitled to dividend, with $3.4 million out of taxpayer's gross dividend of $22.5 million withheld by foreign corporation and paid in Netherlands tax, was a transaction that had economic substance and a business purpose, and which thus could not be disregarded for federal tax purposes.

6. Internal Revenue ⚿3125

The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed, for federal tax purposes.

7. Internal Revenue ⚿3110

For tax purposes, pre-tax income is pre-tax income, regardless of the timing or origin of the tax.

8. Internal Revenue ⚿4099

Purpose of Internal Revenue Code's foreign tax credit provisions is to reduce international double taxation.

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Thomas James Sawyer (argued), Richard Bradshaw Farber, U.S. Dept. of Justice, Tax Div., Charles Casazza, Clerk, U.S. Tax Court, Richard W. Skillman Chief Counsel, IRS, Claire Fallon, Acting Asst. Atty. Gen., U.S. Dept. of Justice, Washington, DC, for CIR.

Appeal from the Decision of the United States Tax Court.

Before JONES, SMITH and DeMOSS, Circuit Judges.

EDITH H. JONES, Circuit Judge:

In this case, Compaq Computer Corporation engaged in a foreign stock transaction involving the purchase and resale of American Depository Receipts (ADRs). The Tax Court held that because the ADR transaction lacked economic substance, the transaction should be disregarded for federal income tax purposes. 113 T.C. 214, 1999 WL 735238 (1999). The Eighth Circuit recently decided the same question and concluded as a matter of law that ADR transactions of the sort at issue here have economic substance and a business purpose. We agree with the Eighth Circuit's conclusion and reverse.

BACKGROUND

The facts are stated in the opinion of the Tax Court and are set out only briefly here. An ADR is a trading unit, issued by a trust, that represents ownership of stock in a foreign corporation. Foreign stocks are customarily traded on U.S. stock exchanges using ADRs. An ADR transaction of the kind at issue in this case begins with the purchase of ADRs with the settlement date at a time when the purchaser is entitled to a declared dividend—that is, before or on the record date of the dividend. The transaction ends with the immediate resale of the same ADR with the settlement date at a time when the purchaser is no longer entitled to the declared dividend—that is, after the record date. In the terminology of the market, the ADR is purchased "cum dividend" and resold "ex dividend."

Twenty–First Securities Corporation, an investment firm specializing in arbitrage transactions, proposed to Compaq that Compaq engage in an ADR transaction. Compaq's assistant treasurer, James Tempesta, and treasurer, John Foster, had a one-hour meeting with Twenty–First to discuss this possibility. After a discussion among Tempesta, Foster, and Compaq's chief financial officer, Darryl White, it was decided to go forward with an ADR transaction. Tempesta did not perform a cash-flow analysis before agreeing to the transaction. His investigation of the transaction and of Twenty–First was limited to telephoning a reference and reviewing a Twenty–First spreadsheet analyzing the transaction.

The securities chosen for the transaction were ADR shares of Royal Dutch Petroleum Company. Compaq knew little or nothing about Royal Dutch other than gen-

erally available market information. Without involving Compaq, Twenty–First chose both the sizes and prices of the trades and the identity of the company that would sell the ADRs to Compaq.

On September 16, 1992, Twenty–First, acting on Compaq's behalf, bought ten million Royal Dutch ADRs from the designated seller, which was another client of Twenty–First. Twenty–First immediately sold the ADRs back to the seller. The trades were made in 46 separate New York Stock Exchange (NYSE) floor transactions—23 purchase transactions and 23 corresponding resale transactions—of about 450,000 ADRs each and were all completed in a little over an hour. Any trader on the floor was able to break up any of these transactions by taking part or all of the trade; but none, it appears, did. Because the trades were completed at market prices, no trader had an incentive to break up the transaction. The aggregate purchase price was about $887.6 million, cum dividend. The aggregate resale price was about $868.4 million, ex dividend. Commissions, margin account interest, and fees were about $1.5 million. Pursuant to special NYSE settlement terms, the purchase trades were formally settled on September 17. Pursuant to regular NYSE terms, the resale trades were settled on September 21. Compaq used a margin account with Bear Stearns & Co., a well known securities brokerage firm. Compaq was the shareholder of record of the ADRs on the dividend record date and was therefore entitled to a gross dividend of about $22.5 million. About $3.4 million in Netherlands tax was withheld from Compaq's dividend by Royal Dutch and paid to the Netherlands government. The net dividend, about $19.2 million, was paid directly to Compaq.

On its 1992 U.S. income tax return, Compaq reported about $20.7 million in capital losses on the purchases and resales, about $22.5 million in gross dividend income, and a foreign tax credit of about $3.4 million for the Netherlands tax withheld from the gross dividend. Compaq used the capital loss to offset part of a capital gain of about $231.7 million that Compaq had realized in 1992 from the sale of stock in another company.

The Commissioner sent a notice of deficiency to Compaq for its federal income taxes that cited, among other things, the Royal Dutch transaction. Compaq filed a petition in the Tax Court for redetermination of the deficiencies and of an accuracy-related penalty for negligence asserted for 1992 under Internal Revenue Code (26 U.S.C.) § 6662. Concluding that the transaction should be disregarded for U.S. income tax purposes, the court upheld the deficiencies and the negligence penalty. The court disallowed the gross dividend income, the foreign tax credit, and the capital losses reported by Compaq on its tax return. Compaq then argued that it should at least be allowed to deduct the out of pocket losses—commissions, margin account interest, and fees—that it had incurred in the course of the transaction, but the court held that the expenses could not be deducted. Compaq appealed.

STANDARD OF REVIEW

[1–3] This court reviews the Tax Court's conclusions of law de novo and its factual findings for clear error. *See Frank Lyon Co. v. United States,* 435 U.S. 561, 581 n. 16, 98 S.Ct. 1291, 1302 n. 16, 55 L.Ed.2d 550 (1978); *Chamberlain v. Comm'r,* 66 F.3d 729, 732 (5th Cir.1995). The Tax Court's determinations of mixed questions of law and fact are subject to de novo review. *See Jones v. Comm'r,* 927 F.2d 849, 852 (5th Cir.1991). In particular, "legal conclusion[s]" that transactions are shams in substance are reviewed de

novo. *Killingsworth v. Comm'r,* 864 F.2d 1214, 1217 (5th Cir.1989). *See Frank Lyon Co.,* 435 U.S. at 581 n. 16, 98 S.Ct. at 1302 n. 16 ("The general characterization of a transaction for tax purposes is a question of law subject to review. The particular facts from which the characterization is to be made are not so subject.").[1] This is true even though the Tax Court has characterized some of its determinations as "ultimate findings of fact." 113 T.C. at 219. *See Ratanasen v. Cal. Dep't of Human Servs.,* 11 F.3d 1467, 1469 (9th Cir. 1993).

DISCUSSION

[4, 5] "[W]here . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties." *Frank Lyon Co.,* 435 U.S. at 583–84, 98 S.Ct. at 1303–04. *See Holladay v. Comm'r,* 649 F.2d 1176, 1179 (5th Cir. Unit B Jul.1981) ("[T]he existence of a tax benefit resulting from a transaction does not automatically make it a sham as long as the transaction is imbued with tax-independent considerations."), *cited in Merryman v. Comm'r,* 873 F.2d 879, 881 (5th Cir.1989). The Government has stipulated that aside from its contention that the Royal Dutch transaction lacked economic substance, it has no objection to how Compaq chose to report its tax benefits and liabilities concerning the transaction.

In *Rice's Toyota World, Inc. v. Comm'r,* 752 F.2d 89 (4th Cir.1985), the court held that after *Frank Lyon Co.,* it is appropriate for a court to engage in a two-part inquiry to determine whether a transaction has economic substance or is a sham that should not be recognized for income tax purposes. "To treat a transaction as a sham, the court must find that the taxpayer was motivated by *no business purposes* other than obtaining tax benefits in entering the transaction, and that the transaction has *no economic substance* because no reasonable possibility of a profit exists." *Id.* at 91 (emphasis added). *See id.* ("[S]uch a test properly gives effect to the mandate of the Court in *Frank Lyon* that a transaction cannot be treated as a sham unless the transaction is shaped *solely* by tax avoidance considerations.") (emphasis added). Other courts have said that business purpose and reasonable possibility of profit are merely factors to be considered in determining whether a transaction is a sham. *See, e.g., ACM Partnership v. Comm'r,* 157 F.3d 231, 247 (3d Cir.1998) ("[T]hese distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.") (citation omitted); *James v. Comm'r,* 899 F.2d 905, 908–09 (10th Cir.1990). Because we conclude that the ADR transaction in this case had both

1. Decisions such as *Freytag v. Comm'r,* 904 F.2d 1011, 1015–16 (5th Cir.1990), *aff'd on other grounds,* 501 U.S. 868, 111 S.Ct. 2631, 115 L.Ed.2d 764 (1991), state that this court reviews findings that transactions are shams for clear error. In keeping with *Frank Lyon Co.,* we read such statements as referring only to genuine factual findings (e.g., a finding that a transaction was a "sham in fact," that is, that the transaction never occurred, *see Killingsworth,* 864 F.2d at 1216 & n. 3; *James v. Comm'r,* 899 F.2d 905, 908 n. 4 (10th Cir. 1990)), not to conclusions of law. *See Killingsworth,* 864 F.2d at 1217; *Sacks v. Comm'r,* 69 F.3d 982, 986 (9th Cir.1995); *James,* 899 F.2d at 909 & n. 5.

economic substance and a business purpose, we do not need to decide today which of these views to adopt.

The Tax Court reasoned that Compaq's ADR transaction had neither economic substance nor a non-tax business purpose. The court first concluded that Compaq had no reasonable opportunity for profit apart from the income tax consequences of the transaction. The court reached this conclusion by employing a curious method of calculation: in computing what it called Compaq's net "cash flow" from the transaction, the court assessed neither the transaction's pre-tax profitability nor its post-tax profitability. Instead, the court assessed profitability by looking at the transaction after Netherlands tax had been imposed but before considering U.S. income tax consequences. The court subtracted Compaq's $20.7 million in capital losses, not from the $22.5 million gross dividend, but from the $19.2 million net dividend.[2] The court then ignored the $3.4 million U.S. foreign tax credit that Compaq claimed corresponding to the $3.4 million Netherlands tax. Put otherwise, in determining whether the ADR transaction was profitable, the court treated the Netherlands tax as a cost of the transaction, but did not treat the corresponding U.S. tax credit as a benefit of the transaction. The result of this half pre-tax, half after-tax calculation was a net loss figure of roughly $1.5 million.

The court rejected Compaq's argument that it had a profit prior to the assessment of tax.

> [Compaq] used tax reporting strategies to give the illusion of profit, while simultaneously claiming a tax credit in an amount (nearly $3.4 million) that far exceeds the U.S. tax (of $640,000) attributed to the alleged profit, and thus is available to offset tax on unrelated transactions.... By reporting the gross amount of the dividend, when only the net amount was received, petitioner created a fictional $1.9 million profit as a predicate for a $3.4 million tax credit.

113 T.C. at 222. The court said that the intention and effect of the transaction were to capture a tax credit, not substantive ownership of Royal Dutch ADRs, and that the transaction had been arranged so as to minimize the risks associated with it. *See id.* at 223–24.

As for Compaq's business purpose, the Tax Court concluded that Compaq was motivated only by the expected tax benefits of the ADR transaction. Among other things, the court said, Compaq had not engaged in a businesslike evaluation of the transaction. *See id.* at 224–25.

The Tax Court's decision is in conflict with *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir.2001).[3] In *IES*, the

2. The Tax Court did this even though the Government had admitted that according to generally accepted accounting principles (to which the Government cited no exceptions), the entire amount of the gross dividend must be reported as income.

3. The Tax Court's decision in this case has been subject to extensive commentary, friendly and not so friendly. *See, e.g.,* Marc D. Teitelbaum, *Compaq Computer and IES Industries—The Empire Strikes Back,* 20 Tax Notes Int'l 791 (2000) (disagreeing sharply with Tax Court); David P. Hariton, *Sorting Out the Tangle of Economic Substance,* 52 Tax Law. 235, 273 (1999) ("... I am not sure Compaq is getting away with enough in this transaction for a court to disallow the results for lack of economic substance; to find otherwise might represent too great an incursion into our objective system for determining tax liabilities."); Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters,* 54 SMU L.Rev. 47, 54 (2001) ("Transactions involving ... foreign tax-credits on dividend-stripping transactions exist in the hinterland between merely aggressive transactions and tax shel-

court held as a matter of law that an ADR transaction identical to this one was not a sham transaction for income tax purposes.[4] Undertaking the two-part inquiry set out in *Rice's Toyota World,* 752 F.2d at 91–92, the court declined to decide whether a transaction would be a sham if either economic substance or business purpose, but not both, was present. *See IES,* 253 F.3d at 353–54. Instead, the court concluded that both economic substance and business purpose were present in the transaction before it.

[6] Turning first to economic substance, the court rejected the argument that the taxpayer purchased only the right to the net dividend, not the gross dividend. "[T]he economic benefit to IES was the amount of the *gross* dividend, before the foreign taxes were paid. IES was the legal owner of the ADRs on the record date. As such, it was legally entitled to retain the benefits of ownership, that is, the dividends due on the record date." *Id.* at 354. The court said that the part of the gross dividend withheld as taxes by the Dutch government was as much income to the taxpayer as the net dividend remaining after taxes. The court relied on the venerable principle, articulated in *Old Colony Trust Co. v. Comm'r,* 279 U.S. 716, 729, 49 S.Ct. 499, 504, 73 L.Ed. 918 (1929), that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." In *Old Colony Trust Co.,* the Supreme Court held that when an employer pays an employee's income taxes, the payment of the taxes constitutes income to the employee. Similarly, in *Diedrich v. Comm'r,* 457 U.S. 191, 199–200, 102 S.Ct. 2414, 2420, 72 L.Ed.2d 777 (1982), the Court held that when a donor of a gift of property conditions the gift on the donee's paying the gift tax owed by the donor on the gift, the donee's payment of the donor's gift tax obligation constituted income to the donor.

The *IES* court saw no reason why the *Old Colony Trust Co.* principle should not apply to the payment of foreign tax by withholding. "The foreign corporation's withholding and payment of the tax on IES's behalf is no different from an employer['s] withholding and paying to the government income taxes for an employee: the full amount before taxes are paid is considered income to the employee." *IES,* 253 F.3d at 354. When the full amount of the gross dividend was counted as income to the taxpayer, the transaction resulted in a profit to the taxpayer. *See id.*

As for business purpose, the court said that "[a] taxpayer's subjective intent to avoid taxes . . . will not by itself determine whether there was a business purpose to a transaction." *Id.* at 355. Compare *Holladay,* 649 F.2d at 1179. The court rejected the Government's argument that because the ADR transaction carried no risk of loss, it was a sham. The court noted that

ters, the border crossed as artificiality increases and tax benefits become more unreasonable.'') (footnote omitted); George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson From History,* 54 SMU L.Rev. 209, 222 (2001) (answer to question whether Compaq transaction should be disallowed for tax purposes ''may not be so easy after all''); David P. Hariton, *Tax Benefits, Tax Administration, and Legislative Intent,* 53 Tax Law. 579, 609 (2000) (*Compaq* was ''rightly decided [by the Tax Court] perhaps, but without a clear analysis''); Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case,* 88 Tax Notes 221 (2000) (generally endorsing Tax Court's approach); David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters,* 54 SMU L.Rev. 73, 79 (2001) (''I think the[Compaq] transaction[] w[as] clearly in the shelter camp.'').

4. The Commissioner concedes that the transaction at issue in *IES* is identical to that at issue in this case.

some risk, minimal though it may have been, attended the transaction. That the taxpayer had tried to reduce the risks did not make it a sham. "We are not prepared to say that a transaction should be tagged a sham for tax purposes merely because it does not involve excessive risk. IES's disinclination to accept any more risk than necessary in these circumstances strikes us as an exercise of good business judgment consistent with a subjective intent to treat the ADR trades as money-making transactions." *IES,* 253 F.3d at 355.

The court further noted that the ADR transactions had not been conducted by alter egos or by straw entities created by the taxpayer simply for the purpose of facilitating the transactions. Instead, "[a]ll of the parties involved . . . were entities separate and apart from IES, doing legitimate business before IES started trading ADRs and (as far as we know) continuing such legitimate business after that time." *Id.* Each individual ADR trade was an arm's-length transaction. *See id.* at 356.

We agree with the *IES* court and conclude that the Tax Court erred as a matter of law by disregarding the gross amount of the Royal Dutch dividend and thus ignoring Compaq's pre-tax profit on the ADR transaction. We add the following comments.

[7] First, as to economic substance: the Commissioner does not explain why the *Old Colony Trust Co.* principle does not apply here. That the tax was imposed by the Netherlands rather than by the United States, or that it was withheld rather than paid at the end of the tax year, is irrelevant to how the part of the dividend corresponding to the tax should be treated for U.S. income tax purposes. Pre-tax income is pre-tax income regardless of the timing or origin of the tax. *See Old Colony Trust Co.,* 279 U.S. at 729, 49 S.Ct. at 504 ("It is . . . immaterial that the taxes were directly paid over to the government [by the taxpayer's employer, rather than by the taxpayer]."); *Riggs Nat'l Corp. v. Comm'r,* 163 F.3d 1363, 1365 (D.C.Cir.1999) ("In calculating his United States tax liability, the lender must include in gross income the interest payment he receives from the borrower *and* the Brazilian tax paid (on his behalf) by the borrower to the Brazilian tax collector."); *Reading & Bates Corp. v. United States,* 40 Fed. Cl. 737, 750 (1998) ("The indemnification agreement at issue results in taxable income to plaintiff because it contractually discharges plaintiff's Egyptian tax obligation.").[5] Because Compaq was entitled to payment of the dividend as of the record date, Compaq was liable for payment of tax on the dividend; accordingly, the payment of Compaq's Netherlands tax obligation by Royal Dutch was income to Compaq. *See* 113 T.C. at 219 ($3.4 million payment to Netherlands "represent[ed] withholding amounts for dividends paid to U.S. residents" under treaty between U.S. and Netherlands); *IES,* 253 F.3d at 351–52, 354; Treas. Reg. § 1.901–2(f)(1) ("The person by whom tax is considered paid for purposes of [the foreign tax credit provisions of the Revenue Code] is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax."); Treas. Reg. § 1.901–2(f)(2)(i) ("Tax is con-

5. Indeed, the Internal Revenue Service has stated in a revenue ruling that "United States shareholders of foreign corporations should report, for Federal income tax purposes, the gross amount of dividends received from such corporations without reduction for withholding of the foreign income tax thereon." Rev. Rul. 57–516, 1957–2 C.B. 435, 1957 WL 11114.

sidered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability."). Indeed, the Commissioner admitted in this case that according to generally accepted accounting principles, the entire amount of Compaq's gross dividend must be reported as income. If the $3.4 million had been paid to the United States (whether by withholding or at the end of the tax year) instead of the Netherlands, there would have been no argument that this money was not income to Compaq. It follows that the gross Royal Dutch dividend, not the dividend net of Netherlands tax, should have been used to compute Compaq's pre-tax profit.

The Tax Court also erred by failing to include Compaq's $3.4 million U.S. tax credit when it calculated Compaq's after-tax profit. 113 T.C. at 223. This omission taints the court's conclusion that the "net economic loss" from the transaction after tax was about $1.5 million. If the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction's net cash flow, tax law effects should be counted when they add to cash flow. To be consistent, the analysis should either count all tax law effects or not count any of them. To count them only when they subtract from cash flow is to stack the deck against finding the transaction profitable.[6] During this litigation, the I.R.S. has consciously chosen to try to stack the deck this way. *See* I.R.S. Notice 98–5, 1998–1 C.B. 334, 1997 WL 786882 ("In general, reasonably expected economic profit will be determined by taking into account foreign tax consequences (but not U.S. tax consequences) [of transactions]. . . . In general, expected economic profit will be determined by taking into account expenses associated with an arrangement, without regard to whether such expenses are deductible in determining taxable income. For example, in determining economic profit, foreign taxes will be treated as an expense."). The Commissioner, however, has provided no reason to endorse its approach and ignore *Old Colony Trust Co.*[7] That the Government would get more money from taxpayers does not suffice.

[8] To un-stack the deck and include the foreign tax credit in calculating Compaq's after-tax profit from the Royal Dutch transaction does not give Compaq a windfall. The purpose of the Revenue Code's foreign tax credit provisions is to reduce international double taxation. *See, e.g., Norwest Corp. v. Comm'r*, 69 F.3d 1404, 1407 (8th Cir.1995). Compaq reported its gross Royal Dutch dividend income to both the United States and the Netherlands. Without the tax credit, Compaq would be required to pay tax twice—first to the Netherlands through withholding on the gross dividend, and then to the United States—on the same dividend income. Taking the tax credit into account, Com-

6. The Tax Court's assertion that "[i]f we follow [Compaq]'s logic, . . . we would conclude that [Compaq] paid approximately $4 million in worldwide income taxes on . . . $1.9 million in profit" suffers from the same flaw. 113 T.C. at 222. When Compaq's $3.4 million U.S. tax credit is counted in the calculation, Compaq's net worldwide tax liabilities arising from the transaction amount only to $644,000. In addition, the assertion ignores the fact that only about $644,000 of the $4 million was paid on Compaq's $1.9 million pre-tax profit. The rest of the $4 million was not paid on the profit; rather, the tax was paid (to the Netherlands) on the gross amount of the Royal Dutch dividend.

7. At oral argument, counsel for the Government admitted that he had found no case supporting the proposition that foreign tax on a transaction should be treated as an expense in determining whether the transaction was profitable.

paq owed roughly $644,000 more in worldwide income tax liability as a result of the transaction than it would have owed had the transaction not occurred. Although the United States lost $2.7 million in tax revenues as a result of the transaction, that is only because the Netherlands gained $3.4 million in tax revenues.

If the effects of the transaction are computed consistently, Compaq made both a pre-tax profit and an after-tax profit from the ADR transaction. Subtracting Compaq's capital losses from the gross dividend rather than the net dividend results in a net pre-tax profit of about $1.894 million. Compaq's U.S. tax on that net pre-tax profit was roughly $644,000. Subtracting $644,000 from the $1.894 million results in an after-tax profit of about $1.25 million. The transaction had economic substance.

Second, as to business purpose: even assuming that Compaq sought primarily to get otherwise unavailable tax benefits in order to offset unrelated tax liabilities and unrelated capital gains, this need not invalidate the transaction. *See Frank Lyon Co.,* 435 U.S. at 580, 98 S.Ct. at 1302 ("The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction.") (footnote omitted); *Holladay,* 649 F.2d at 1179; *ACM Partnership,* 157 F.3d at 248 n. 31 ("[W]here a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations."); *Helvering v. Gregory,* 69 F.2d 809, 810 (2d Cir.1934) (Hand, J. Learned) ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."), *aff'd,* 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).[8] Yet the

8. In particular, the fact that Compaq had a large unrelated capital gain in 1992 does not mean that Compaq had an impermissible motive in seeking to engage in the transaction. The capital gain, of course, made it possible for Compaq to obtain an otherwise unavailable tax benefit from the ADR transaction by offsetting its $20.7 million in capital losses from the transaction against the gain. 26 U.S.C. § 1211(a) (corporation's "losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges"); *Circle K Corp. v. United States,* 23 Cl.Ct. 665, 670 (1991). If Compaq had had no capital gain whatsoever in 1992, it would still have had to pay tax on the gross amount of its $22.5 million dividend from Royal Dutch, which—in the absence of a capital gain against which to offset its capital losses—would have resulted in a substantial after-tax loss to Compaq. *But cf.* 26 U.S.C. § 1212 (allowing for certain carrybacks and carryovers of capital losses against capital gains realized in years different from the years in which the losses were realized); *Circle K Corp.,* 23 Cl.Ct. at 670. Put otherwise, the availability of a capital gain against which to offset the capital losses from the ADR transaction was a necessary precondition to the profitability of the transaction on an after-tax basis. A sensible taxpayer would have engaged in such a transaction only if it had a capital gain against which to offset the capital losses that the taxpayer knew would result from the transaction. All this is unremarkable and is no evidence that Compaq had an impermissible motive.

According to the Commissioner, tax-exempt organizations with no use for U.S. income tax credits have an incentive to loan out their ADRs to non-tax-exempt persons in transactions of the kind at issue in this case. The non-exempt persons can use the capital losses and tax credits resulting from ADR transactions to offset unrelated capital gains and tax liabilities. The fact that the differing tax attributes of investors make ADRs more valuable for some investors than for others does not deprive ADR transactions of economic substance for purposes of the tax laws. The possible benefits from ADR transactions for

evidence in the record does not show that Compaq's choice to engage in the ADR transaction was solely motivated by the tax consequences of the transaction. Instead, the evidence shows that Compaq actually and legitimately also sought the (pre-tax) $1.9 million profit it would get from the Royal Dutch dividend of approximately $22.5 million less the $20.7 million or so in capital losses that Compaq would incur from the sale of the ADRs ex dividend.

Although, as the Tax Court found, the parties attempted to minimize the risks incident to the transaction, those risks did exist and were not by any means insignificant. The transaction occurred on a public market, not in an environment controlled by Compaq or its agents. The market prices of the ADRs could have changed during the course of the transaction (they in fact did change, 113 T.C. at 218); any of the individual trades could have been broken up or, for that matter, could have been executed incorrectly; and the dividend might not have been paid or might have been paid in an amount different from that anticipated by Compaq. *See IES*, 253 F.3d at 355. The absence of risk that can legitimately be eliminated does not make a transaction a sham, *see id.;* but in this case risk was present. In light of what we have said about the nature of Compaq's profit, both pre-tax and post-tax, we conclude that the transaction had a sufficient business purpose independent of tax considerations.[9]

Because the Royal Dutch ADR transaction had both economic substance and a non-tax business purpose, it should have been recognized as valid for U.S. income tax purposes. This court's decisions applying the economic substance doctrine to disregard various transactions are not to the contrary. Without enumerating all of the decisions, we mention some to give a flavor of the differences between the facts at issue in the decisions and in this case. In *Freytag v. Comm'r,* 904 F.2d 1011 (5th Cir.1990), *aff'd on other grounds,* 501 U.S. 868, 111 S.Ct. 2631, 115 L.Ed.2d 764 (1991), this court affirmed a Tax Court decision disallowing losses allegedly incurred as a result of investments in a commodity straddle program. The taxpayers' investment agent had "absolute authority over the pricing and timing of the transactions" at issue, which "occurred in [a] self-contained market of its own making." 904 F.2d at 1016.[10] In *Merryman,* a

investors with unrelated capital gains and tax liabilities are analogous to the benefits that taxpaying investors (especially investors with high incomes), but not tax-exempt persons, get from the purchase of tax-exempt bonds with lower yields than the pre-tax yields available from non-exempt bonds. *See* Yin, *supra,* at 222–23. In both instances the benefits would not exist were it not for the investors' individual tax attributes.

9. In *IES,* the court noted the Tax Court's assertion in this case that in light of Compaq's limited investigation of the risks of the Royal Dutch transaction, Compaq had had no non-tax business purpose in agreeing to the transaction. 253 F.3d at 355. Even if we agreed with the Tax Court that Compaq had not adequately investigated the risks, it would not make a difference to the outcome of this case. Though Compaq could have done more to evaluate the risks of the transaction, the process it used does not alone prove a lack of business purpose for a transaction that had real risks. It should also be noted that in this case, as in *IES,* the taxpayer declined to go forward with all of the transactions that Twenty–First had proposed. *See* 113 T.C. at 216; *IES,* 253 F.3d at 355.

10. Similarly, in *Fender v. United States,* 577 F.2d 934, 937 (5th Cir.1978), the taxpayers' sale-and-repurchase transactions involving bonds were not recognized where the taxpayers had ''sufficient influence'' over the other party to the transaction to ''remove any substantial risk'' that they would be unable to recapture their apparent losses from the sale of the bonds by repurchasing the bonds. And in *Salley v. Comm'r,* 464 F.2d 479 (5th Cir.

business partnership was disregarded for tax purposes because "the formation and role of the partnership served no other purpose except tax avoidance;" a number of facts found by the Tax Court indicated that the partnership lacked economic reality and was a mere formality. *See id.* at 881–83. In *Killingsworth*, this court affirmed a Tax Court decision concluding that a scheme of option hedge or option straddle transactions lacked economic substance. We relied on Revenue Code section 108, a provision that is not relevant to this case, and noted that the transactions "appear[ed] to be devoid of profit making potential." 864 F.2d at 1218. In *Holladay,* this court affirmed the Tax Court's decision to disallow half of certain tax benefits that an agreement between two joint venturers allocated to only one of the venturers. The allocation had no valid non-tax business purpose. 649 F.2d at 1180. Compare *Boynton v. Comm'r,* 649 F.2d 1168, 1173–74 (5th Cir. Unit B Jul.1981).

In this case, by contrast, the ADR transaction had both a reasonable possibility of profit attended by a real risk of loss and an adequate non-tax business purpose. The transaction was not a mere formality or artifice but occurred in a real market subject to real risks. And, as has been discussed, the transaction gave rise to a real profit whether one looks at the transaction prior to the imposition of tax or afterwards.

For the foregoing reasons, the Tax Court erred as a matter of law in disallowing Compaq's identification of gross dividend income, a foreign tax credit, and capital losses associated with the Royal Dutch ADR arbitrage transaction. It is unnecessary to reach the alternative arguments for reversal offered by Compaq: first, that the statutory foreign tax credit regime implicitly displaces the economic substance doctrine; and second, that a 1997 amendment to the foreign tax credit scheme, which added what is now Internal Revenue Code § 901(k), implies that ADR transactions that took place before the amendment are to be recognized for tax purposes. Because we reverse the Tax Court's decision concerning the underlying transaction, it follows that the court erred in imposing the negligence penalty and that the court's holding that Compaq was not entitled to deduct its out of pocket losses becomes superfluous.

The decision of the Tax Court is REVERSED.

Neoma SHAFER; et al., Plaintiffs,

Judith Ann Parks, Plaintiff–Appellee,

v.

ARMY & AIR FORCE EXCHANGE SERVICE; United States Department of Defense, Defendants–Appellants.

No. 00–10854.

United States Court of Appeals,
Fifth Circuit.

Jan. 11, 2002.

Former employee brought Title VII action against former employer. The United States District Court for the Northern District of Texas, Jerry L. Buchmeyer, Chief Judge, approved and adopted special

1972), this court held that interest payments made by the taxpayers on loans from an insurance company that they controlled were not deductible. *See id.* at 480.

IES INDUSTRIES, INC., and Subsidiaries, Plaintiff,

Alliant Energy Corporation, Successor in Interest to IES Industries, Inc., and Subsidiaries, Appellant/Cross–Appellee,

v.

UNITED STATES of America, Appellee/Cross–Appellant.

No. 00–1221, 00–1535.

United States Court of Appeals, Eighth Circuit.

Submitted: Jan. 10, 2001.

Filed: June 14, 2001.

Owner of nuclear power plant brought action challenging decision of Internal Revenue Service (IRS) to deny its claims for refunds resulting from trades of American Depository Receipts (ADRs) and from environmental cleanup cost assessments under Energy Policy Act of 1992 (EPACT). The United States District Court for the Northern District of Iowa, Edward J. McManus, District Judge, held that ADR transactions were sham, but allowed deduction for cleanup costs. On parties' cross-appeals, the Court of Appeals, Bowman, Circuit Judge, held that: (1) owner's trades of ADRs were not sham transactions, and (2) owner's liability for cleanup assessments was incurred when EPACT was enacted.

Affirmed in part, reversed in part, and remanded.

1. Federal Courts ⚿766, 776

Court of Appeals reviews de novo district court's decision to grant summary judgment, and will affirm if record shows no genuine issues of material fact and moving party is entitled to judgment as matter of law.

2. Internal Revenue ⚿3255, 3260, 4100

Domestic taxpayer's purchases and resales of American Depository Receipts (ADRs) from tax-exempt holders at time of dividend accrual were not sham transactions for tax purposes, and thus taxpayer was entitled to claim foreign tax credit on dividends, as well as capital losses from purchases and sales, even though taxpayer's risk was minimal and resale usually occurred within a few hours of purchase; economic benefit to taxpayer was amount of gross dividend, before foreign taxes were paid by foreign corporation that issued stock represented by ADRs, taxpayer bore risk that announced ADR dividends would not be paid, all parties involved were entities separate and apart from taxpayer, and each trade was arm's-length transaction.

3. Internal Revenue ⚿3071

Taxpayer's subjective intent to avoid taxes will not by itself determine whether there was business purpose to transaction.

4. Internal Revenue ⚿3273

Liability of owner of nuclear power plant for special assessments under Energy Policy Act of 1992 (EPACT) to fund for decontamination and decommissioning of uranium-enrichment plants was incurred, for tax deductibility purposes, when EPACT was enacted, not when payments to fund were made, even though cleanup did not begin until money for it was appropriated and collected; amount of assessments was calculated based on past uranium-enrichment services actually used by owner. 26 U.S.C.A. § 461(h)(4); Atomic Energy Act of 1954, §§ 1801 to 1805, as amended, 42 U.S.C.A. §§ 2297g to 2297g–4; 26 C.F.R. § 1.451–1(a).

Thomas C. Borders, argued, Chicago, IL (Matthew P. Larvick and Diane Kutzko, on the brief), for appellant/cross-appellee.

Richard Farber, argued, Washington, DC (Paul M. Junghans and Michelle B. O'Connor, on the brief), for appellee/cross-appellant.

Before RICHARD S. ARNOLD and BOWMAN, Circuit Judges, and KYLE,[1] District Judge.

BOWMAN, Circuit Judge.

IES Industries, Inc.,[2] appeals from the order of the District Court granting the United States summary judgment on IES's claim for tax refunds to which IES contends it is entitled as a result of securities trades that the court held to be sham transactions. The United States cross appeals, challenging the District Court's decision granting summary judgment to IES on its second claim for a tax refund, that IES is entitled to deduct fifteen years' worth of environmental cleanup cost assessments in the tax year in which the amount of the liability was determined. We affirm in part and reverse in part.

I. IES's Appeal

[1] We review de novo a district court's decision to grant summary judgment, and will affirm if the record shows no genuine issues of material fact and the moving party is entitled to judgment as a matter of law. *Land v. Washington County, Minn.*, 243 F.3d 1093, 1095 (8th Cir. 2001). The material facts are undisputed; the question of law before us is "[t]he general characterization of a transaction for tax purposes." *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n. 16, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978). Before we discuss the legal question, we first set out in some detail the facts leading to IES's claim for a tax refund, drawing heavily on the parties' very helpful stipulation of facts.

The transactions at issue involved American Depository Receipts, or ADRs. ADRs are publicly traded securities, or receipts, fully negotiable in U.S. dollars, that represent shares of a foreign corporation held in trust by a U.S. bank. The owner of an ADR is entitled to all dividends and capital gains associated with the ADR, with those moneys taxable in the home country of the foreign corporation.

Before a dividend is paid on an ADR, the corporation issuing the stock will declare the amount to be paid, the record date, and the payment date. The owner of the ADR as of the close of business on the record date will be paid the dividend. The payment date for the dividend ordinarily is several weeks or more after the record date. When a dividend is paid, tax is withheld, usually by the foreign corporation, before the funds are transferred to the United States. In this case, the ADR dividends were paid by corporations in the United Kingdom, the Netherlands, and Norway. Under the terms of tax treaties between those countries and the United States, the withholding rate on ADR dividends paid to U.S. citizens is 15%. Thus the record owner of the ADR would receive 85% of the dividend in cash, but the gross income—100% of the dividend—would be fully taxable in the United States. In these circumstances, the record owner is entitled to a 15% foreign tax credit, a dollar-for-dollar credit against U.S. taxes owed.

1. The Honorable Richard H. Kyle, United States District Judge for the District of Minnesota, sitting by designation.

2. Alliant Energy Corporation is the successor in interest to IES Industries, Inc. The parties and the District Court nevertheless refer to the taxpayer as IES; we will do the same here.

In 1991, Twenty–First Securities Corporation, a securities broker in New York, proposed ADR trading opportunities to IES, an electric utility company in Iowa. After some initial investigation, IES decided to sign on. The trades worked as follows.

Twenty–First was responsible for identifying and locating ADRs whose companies had announced dividends. IES purchased ADRs with a settlement date, or effective trade date, before the record date for the dividend, so that IES was the owner on the record date and therefore entitled to be paid the dividend. IES then promptly sold the ADRs, with a settlement date after the record date. The purchase and sale generally took place within hours of each other, and sometimes in Amsterdam when the U.S. and European markets were closed.

The sellers of the ADRs were tax-exempt entities, such as pension funds. But such entities were exempt only from U.S. taxes; they still were required to pay the 15% foreign tax on any ADR dividends collected. Because they owed no U.S. tax, they could not benefit from the foreign tax credit. Before the dividend record date, the tax-exempt holders of the ADRs loaned them to a counterparty selected by Twenty–First. The counterparty then sold the ADRs short (that is, sold borrowed property) to IES, which then became the actual owner of the ADRs with full right, title, and interest in the ADRs. The counterparty bought back the ADRs after the dividend accrued to IES.

The purchase price of the securities was equal to market price plus 85% of the ADRs' expected gross dividends, that is, the same amount the ADR lender would have received after foreign tax was withheld had it been the record owner entitled to payment of the dividends. In addition, the lender received a deposit of cash (or equivalent) collateral, generally 102% of the market value of the ADRs on loan. The lender would have that collateral available to invest during the term of the loan of the ADRs, thus earning a profit on its loan. IES paid commissions to Twenty–First on the purchases and sales; Twenty–First in turn paid the counterparty a fee, generally $1000 per trade day. IES sold the ADRs back to the lenders at market price.

So, IES purchased ADRs with dividend rights attached, or cum-dividend, for more than it sold them ex-dividend, thus incurring capital losses. IES sought to carry back the losses to offset capital gains received when it sold stock in tax years 1989 and 1990, and thus to receive a refund of capital gains taxes paid in those years. (Capital losses could not be used to offset "ordinary" income, but they could be carried back three years or carried forward five years to offset capital gains.)

While generating capital losses on each ADR purchase/sale combination, IES nevertheless made a profit because it was entitled to the dividends, which actually exceeded the capital losses. IES retained the dividends, which were ordinary income to the company, paid the 15% foreign tax, and therefore claimed a 15% foreign tax credit in the United States. IES claimed deductions for the commissions it paid Twenty–First. Further, IES purchased the ADRs on margin and incurred interest expense that it also claimed as a deduction. After 1992, IES did not engage in any additional ADR trades. By then, it had offset all of its 1989 and 1990 capital gains with the capital losses incurred as a result of the ADR trades.

Thus, for its 1991 and 1992 taxes, IES:

1. Reported gross dividend income on the ADR dividends of nearly $90.8 million.

2. Claimed a foreign tax credit on the ADR dividends for the amount of foreign tax withheld and paid to foreign governments, over $13.5 million.

3. Recognized capital losses from the ADR purchases and sales and sought to carry back more than $82.7 million to offset capital gains earned in 1989 and 1990. An additional $56,643 in capital losses offset capital gains earned in 1992.

4."[I]ncluded the commissions it paid to purchase ADRs in its basis, and deducted the commissions paid to sell ADRs from the amount realized." Brief of Appellant IES at 17.

5. Deducted over $3.1 million in interest expense incurred in purchasing the ADRs on margin.

The Internal Revenue Service (IRS) audited IES's tax returns for 1991 and 1992 and disallowed the claimed capital losses and the concomitant 1989 and 1990 capital loss carrybacks. The IRS further disallowed the ADR-related foreign tax credit and eliminated the reported dividend income. Deductions for interest expenses, commissions, and one-half of the foreign income tax paid on the ADR transactions were allowed.[3]

IES sought a refund of over $26 million, plus interest. The government rejected the claim and IES filed suit in the District Court. The court granted the government's motion for summary judgment, concluding that the transactions "were shaped solely by tax avoidance considerations, had no other practical economic effect, and are properly disregarded for tax purposes." Order of Sept. 22, 1999, at 3. IES appeals and we reverse.

[2] The District Court viewed "[t]he question presented" as "whether these transactions are a sham and therefore to be disregarded for tax purposes." *Id.* at 3. In determining whether a transaction is a sham for tax purposes, the Eighth Circuit has applied a two-part test set forth in *Rice's Toyota World, Inc. v. Commissioner,* 752 F.2d 89, 91–92 (4th Cir.1985), which the Fourth Circuit ostensibly found in the Supreme Court's opinion in *Frank Lyon Co. See Shriver v. Comm'r,* 899 F.2d 724, 725–26 (8th Cir.1990). Applying that test, a transaction will be characterized as a sham if "it is not motivated by any economic purpose outside of tax considerations" (the business purpose test), and if it "is without economic substance because no real potential for profit exists" (the economic substance test). *Id.* at 725–26. The *Shriver* Court analyzed the transaction at issue in that case under both parts of the test, but then said in dictum, "[W]e do not read *Frank Lyon* to say anything that mandates a two-part analysis." *Id.* at 727. The Court suggested that a failure to demonstrate either economic substance *or* business purpose—both not required—would result in the conclusion that the transaction in question was a sham for tax purposes. As in *Shriver,* we do not decide whether the *Rice's Toyota World* test requires a two-part analysis because we con-

3. The IRS argued in the District Court that the agency was mistaken to allow IES to claim deductions for interest, commissions, and one-half of the foreign income tax withheld, and sought an offset against any overpayment of taxes by IES (that is, refunds due IES). (The IRS was time-barred from assessing the taxes, I.R.C. § 6501(a), but it could seek to offset any refund due IES by the amount of the taxes, *Lewis v. Reynolds,* 284 U.S. 281, 283, 52 S.Ct. 145, 76 L.Ed. 293, *modified,* 284 U.S. 599, 52 S.Ct. 264, 76 L.Ed. 514 (1932).) The District Court agreed with the government's position that the IRS should not have allowed the deductions; IES also appeals that determination. Our holding here—that IES is entitled to the tax refund it seeks in connection with the ADR trades—resolves this issue as well.

clude that the ADR trades here had both economic substance and business purpose.

The District Court dealt with the sham transaction issue summarily and did not apply, or even mention, the *Rice's Toyota World* test iterated in *Shriver.* After a cursory review of the facts and the law, the court simply concluded that the only change in IES's "economic position" as a result of the ADR transactions was "the transfer of the claim to the foreign tax credit to IES," and therefore that the transactions were shams.[4] Order of Sept. 22, 1999, at 3. Assuming this was an application of the objective economic substance test, we will first consider whether there was a "reasonable possibility of profit . . . apart from tax benefits," that is, whether the transactions had economic substance. *Shriver,* 899 F.2d at 726 (quoting *Rice's Toyota World,* 752 F.2d at 94).

The government insists that, "absent the tax benefits that were the sole reason for the transactions, each series of ADR trade pairs resulted, as pre-planned, in an economic loss." Brief of Appellee United States at 35. According to the government's view of the transaction, "IES purchased only the right to the net dividend—not the gross dividend." *Id.* at 36. Under that view, economic benefit accrues to IES *only* if it receives the foreign tax credit. In other words, the government would have us regard only 85% of the dividends as income to IES, notwithstanding that the IRS treats 100% as income for tax purposes.

We reject the government's argument and agree with IES that the law supports our contrary conclusion: the economic benefit to IES was the amount of the *gross* dividend, before the foreign taxes were paid. IES was the legal owner of the ADRs on the record date. As such, it was legally entitled to retain the benefits of ownership, that is, the dividends due on the record date. While it received only 85% in cash, 100% of the amount of the dividends was income to IES. " '[I]ncome' may be realized by a variety of indirect means." *Diedrich v. Comm'r,* 457 U.S. 191, 195, 102 S.Ct. 2414, 72 L.Ed.2d 777 (1982) (analyzing, and ultimately agreeing with, IRS's position that payment of gift tax by donee, which was obligation of donor, constituted income to donor). In this case, income was realized by the payment of IES's foreign tax obligation by a third party. The fact that the taxes were withheld, and then paid, by the foreign corporation that issued the stock represented by the ADRs, so that IES received only 85% of the dividend in cash, is of no consequence to IES's liability for the tax. "The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Id.* (quoting *Old Colony Trust Co. v. Comm'r,* 279 U.S. 716, 729, 49 S.Ct. 499, 73 L.Ed. 918 (1929)). The foreign corporation's withholding and payment of the tax on IES's behalf is no different from an employer withholding and paying to the government income taxes for an employee: the full amount before taxes are paid is considered income to the employee. *See id.* Because the entire amount of the ADR dividends was income to IES, the ADR transactions resulted in a profit, an economic benefit to IES.

[3] As for the business purpose test, the *Shriver* court explained that the proper inquiry is "whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive,

4. In so holding, the District Court reached the same result as the United States Tax Court in *Compaq Computer Corp. v. Commissioner,* 113 T.C. 214, 1999 WL 735238 (1999), filed just one day before the order in this case.

was involved." *Shriver,* 899 F.2d at 726. In other words, the business purpose test is a subjective economic substance test. The *Shriver* Court considered the district court's "subjective analysis of the taxpayer's intent" and the court's review of such factors as the depth and accuracy of the taxpayer's investigation into the investment. *Id.* To the extent the taxpayer's subjective intent is material, we too will consider factors that are arguably relevant to the inquiry. We do so, however, mindful of the fact that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory v. Helvering,* 293 U.S. 465, 469, 55 S.Ct. 266, 79 L.Ed. 596 (1935). A taxpayer's subjective intent to avoid taxes thus will not by itself determine whether there was a business purpose to a transaction.

In their briefs, both parties discuss the risk of loss inherent in the trades, evidently presuming that the degree of risk goes to IES's subjective intent in engaging in the transactions. The government argues that the transactions must be characterized as shams because there was no risk of loss. We disagree. The risk may have been minimal, but that was in part because IES did its homework before engaging in the transactions. Company officials met twice with Twenty–First representatives and studied the materials provided. After that, IES consulted its outside accountants and its securities counsel for reassurances about the legality of the transactions and their tax consequences. *Cf. Compaq Computer Corp. v. Comm'r,* 113 T.C. 214, 224–25, 1999 WL 735238 (concluding no business purpose existed where taxpayer's "evaluation of the proposed transaction was less than businesslike with [taxpayer's assistant treasurer] committing [taxpayer] to this multimillion-dollar transaction based on one meeting with Twenty–First and on his call to a Twenty–First reference"). As the entity legally entitled to receive the ADR dividends, being the legal owner on the record date, IES likewise bore the risk that the dividend would not be paid. In consideration of that risk and after doing its own investigation, IES rejected some of the ADR trades that Twenty–First proposed. *Cf. id.* at 223 (noting that taxpayer did no investigation or analysis of risks of ADR trades). IES did make some of the trades when the U.S. markets were closed, in order to avoid the risk of fluctuations in market price of the ADRs between the purchase and sale and to prevent a third party from attempting to break up the trades, again demonstrating the exercise of good business judgment. We are not prepared to say that a transaction should be tagged a sham for tax purposes merely because it does not involve excessive risk. IES's disinclination to accept any more risk than necessary in these circumstances strikes us as an exercise of good business judgment consistent with a subjective intent to treat the ADR trades as money-making transactions.

It also is important to note that these were not transactions conducted by alter-egos of IES or straw entities created by IES simply for the purpose of conducting ADR trades. *See Frank Lyon Co.,* 435 U.S. at 580, 98 S.Ct. 1291. All of the parties involved—the foreign corporations, the trusts issuing the ADRs, the tax-exempt ADR owners, Twenty–First, other brokers involved, the counterparties—were entities separate and apart from IES, doing legitimate business before IES started trading ADRs and (as far as we know) continuing such legitimate business after that time. *See United States v. Consumer Life Ins. Co.,* 430 U.S. 725, 737, 97 S.Ct. 1440, 52 L.Ed.2d 4 (1977); *Goldstein v. Comm'r,* 364 F.2d 734, 737–38 (2d Cir. 1966), *cert. denied,* 385 U.S. 1005, 87 S.Ct.

708, 17 L.Ed.2d 543 (1967). "[T]he transaction[s] must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant." *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334, 65 S.Ct. 707, 89 L.Ed. 981 (1945). Each trade was an arm's-length transaction: "what was actually done is what the parties to the transaction purported to do." *Gran v. IRS* (*In re Gran*), 964 F.2d 822, 825 (8th Cir.1992) (citations to quoted cases omitted). The fact that IES took advantage of duly enacted tax laws in conducting the ADR trades does not convert the transactions into shams for tax purposes.[5]

We hold, considering all the facts and circumstances of this case, that the ADR trades in which IES engaged did not, as a matter of law, lack business purpose or economic substance. Accordingly, IES is entitled to summary judgment on its claim for a tax refund. The judgment is reversed and the case is remanded to the District Court for further action consistent with this opinion.

II. The Government's Cross Appeal

At all times relevant to the government's cross appeal, IES was a 70% owner of a nuclear power plant in Iowa. During this period, the government was the exclusive provider of uranium-enrichment services required to fuel such plants. The services were purchased either directly from the United States Department of Energy (DOE)[6] or on a secondary market where utilities that had purchased the services from the DOE resold them to others. Between 1972 and 1992, IES purchased most of the required services from the DOE but did buy some from secondary sources.

In 1992, Congress enacted the Energy Policy Act of 1992, Pub.L. No. 102–486, 106 Stat. 2776 (EPACT). Among other things, EPACT establishes a fund for the decontamination and decommissioning of uranium-enrichment plants. The $480 million in annual deposits to the fund are to come largely from congressional appropriations, but up to $150 million annually (adjusted for inflation) is to be collected for fifteen years (1993 through 2008, or until $2.25 billion, adjusted for inflation, is deposited) from domestic utilities. The amount each utility is assessed is calculated based upon that utility's *previous* use of uranium-enrichment services, regardless of whether those services were purchased directly from the DOE or on the secondary market. *See* 42 U.S.C. §§ 2297g to 2297g–4 (Supp. IV 1992).

Thus, in 1992, IES became liable for fifteen special assessments totaling $16,020,125 (exclusive of the annual adjustment for inflation), and made the first payment in 1993. IES filed an amended corporate federal income tax return for 1992 seeking a tax refund based on its position that the liability for the entire $16 million assessment was incurred in 1992,

5. In 1997, Congress amended the tax code to increase to at least sixteen days the amount of time an ADR must be held within a thirty-day period that includes the dividend record date in order for the foreign taxes paid on the dividend to qualify for the foreign tax credit. I.R.C. § 901(k) (Supp. III 1997). Each side would have us read more into the amendment than the legislative history and proper statutory interpretation permit. On its face, the amendment merely requires a holding period longer than the holding period previously required, thus making ADR transactions like the ones involved in this case much less attractive to taxpayers.

6. Before the DOE, services were purchased from the Atomic Energy Commission, another government entity. Because the specific identity of the provider of enrichment services in this case is of no consequence, we will refer to both as the DOE.

even though none of it had been paid. The IRS denied the refund. IES brought suit in the District Court, which granted summary judgment to IES on this part of IES's tax refund claim.[7]

[4] As an accrual method taxpayer, income to IES is taxable in the year the income is accrued, or earned, even if it is not received in that year. Treas. Reg. § 1.451–1(a). Likewise, a liability

> is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which [1] all the events have occurred that establish the fact of the liability, [2] the amount of the liability can be determined with reasonable accuracy, and [3] economic performance has occurred with respect to the liability.

Id. § 1.461–1(a)(2)(i). Conditions [1] and [2] together compose what is known as the "all events" test. I.R.C. § 461(h)(4). There is no dispute that the "all events" test was satisfied in 1992 with the passage of EPACT. The only issue is whether economic performance has occurred. IES's position is that it has, and therefore IES is entitled to a full deduction of the assessments in tax year 1992. We agree.

The general rule is that economic performance occurs as services are provided to the taxpayer if "the liability of the taxpayer *arises out of* . . . the providing of services to the taxpayer by another person." *Id.* § 461(h)(2)(A)(i) (emphasis added); *accord* Treas. Reg. § 1.461–4(d)(2)(i). If, as IES contends, the liability arose out of the DOE's provision of uranium-enrichment services, then all conditions have been met for full deductibility in tax year 1992. But if not, then, as the government argues, Treas. Reg. § 1.461–4(g)(7) applies:

> In the case of a taxpayer's liability for which economic performance rules are not provided elsewhere in this section or in any other Internal Revenue regulation, revenue ruling or revenue procedure, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed.

In that case, the assessments would be deductible only as paid.

We think the government's position is untenable on these facts and conclude that the EPACT assessments are properly characterized as arising out of the provision of services, all of which services had been provided by the time the EPACT payments were assessed. Accordingly, § 1.461–4(g)(7) is inapplicable.

The relevant facts support our conclusion. The amount of the assessments was calculated based on the uranium-enrichment services actually used by IES—including those that were purchased on the secondary market. This establishes a direct link between the amount assessed and the services provided. It is the *prior* generation of uranium-enrichment services at the DOE's plants that resulted in the need for decommissioning and decontamination. Users pay proportionately: the more they used the services before the passage of EPACT, the more they pay to clean up the contamination that resulted from the provision of those past services. If cleanup costs had been considered up-front, they likely would have been included in the cost of the services provided, to the same effect as the after-the-fact assessment. Only those utilities that were actually provided services before 1992 pay now for cleanup.[8]

7. It was this refund that the IRS sought to offset when it challenged certain deductions it had previously allowed for expenses associated with the ADR trades. *See supra* n. 3.

8. The government contends that its position,

The government asserts that EPACT's legislative history demonstrates that the contamination resulting from the production of enriched uranium went unrealized until *after* the services had been provided, and so the special assessments are intended to cover *future* costs of cleaning up. According to this theory, the liability thus arose out of the passage of EPACT, not the provision of previous services. We find this argument specious. Assuming, arguendo, that the government's interpretation of the legislative history is accurate (much less relevant), that reading does not support the government's position in this appeal. The assessments are based on the services provided even though the cleanup did not begin until the money for it was appropriated and collected. It cannot be denied that it was the operation of the facilities, which operation occurred only to provide enriched-uranium services, that made the decommissioning and decontamination of those facilities necessary, then, now, or into the future. Again, the correlation between the assessments and the services provided to each assessed utility could not be more direct.

The government maintains that the opinion in *Yankee Atomic Electric Co. v. United States*, 112 F.3d 1569 (Fed.Cir. 1997), *cert. denied*, 524 U.S. 951, 118 S.Ct. 2365, 141 L.Ed.2d 735 (1998), should control the result here. We disagree. *Yankee Atomic* is a constitutional law case, so the "arising out of" part of the economic-performance test for the timing of deductible liabilities is never discussed, and the issues that are discussed are not analogous. The government's heavy reliance on the *Yankee Atomic* decision suggests the government fundamentally misunderstands the opinion.

In *Yankee Atomic*, a utility challenged the EPACT assessments as an unconstitutional exercise of Congress's taxing power. The Federal Circuit concluded otherwise, holding that EPACT "is a sovereign act because it is designed to spread the costs associated with the decontamination and decommissioning over all domestic utilities that used the DOE's uranium enrichment services." 112 F.3d at 1581. According to the government, *Yankee Atomic* is "directly relevant" because the court held "that the proximate cause of a utility's liability for the special assessments was the enactment of EPACT." Brief of United States as Cross Appellant at 59.

The government is simply wrong. The *Yankee Atomic* court repeatedly connected the EPACT assessment to the past use of services provided. *See, e.g.*, 112 F.3d at 1571 (describing EPACT liability as "a special assessment to aid in funding the clean-up costs associated with the facilities that provided those enrichment services"); 1572 (noting that Congress recognized "there would be large costs associated with decontaminating and decommissioning the facilities that had previously been used to provide enrichment services"), ("Because this decontamination and decommissioning

"that IES's liability for special assessments did not arise out of DOE's provision of enrichment services to it . . . , is confirmed by the fact that the amount of the special assessments made against IES took into account the enrichment services that IES purchased on the secondary market as well as the enrichment services that IES contracted for with DOE." Reply Brief of Cross Appellant United States at 4. The government does not explain why that should be so, and we find the contention counterintuitive. The facilities required decommissioning and decontamination as a direct result of their production of enriched-uranium services. Under EPACT those utilities that ultimately used the services were liable for the assessments, not those that purchased services but never used them. The nexus between the EPACT liability of the beneficial users of the services and the *previous* provision of those services to such users is clearly established.

fiscal problem was not recognized until the 1980s, the prices charged in the Government's past uranium enrichment contracts had not accounted for the problem."); 1575 ("[T]he Act targets whichever utility eventually used and benefited from the DOE's enrichment services."). In fact, in *Yankee Atomic*, even though the utility challenging the assessments had closed its nuclear facilities before EPACT was enacted, the court held the utility was liable for the assessments because it had used the services, *id.* at 1581, that is, the liability arose out of the provision of the services. If anything, the *Yankee Atomic* opinion supports IES's position, not the government's.

The government also relies on *Yankee Atomic* for its alternative (and poorly developed) argument that "the liability also properly could be characterized as 'taxes' under subparagraph (g)(6)." Brief of United States as Cross Appellant at 60. If that were the case, the assessment would be deductible only when paid. *See* Treas. Reg. § 1.461–4(g)(6) ("[I]f the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax."). In support of this tax theory, the government merely cites *Yankee Atomic*, wherein the court said, "[T]he assessment appears to be very similar to . . . a general tax that falls proportionally on all utilities that benefited from the DOE's uranium enrichment services." *Yankee Atomic*, 112 F.3d at 1576. In a footnote, the government suggests that, because the assessments were imposed to support the government, they are taxes. The government's "fair reading" of the *Yankee Atomic* opinion—"that the special assessments are 'taxes' governed by Section 1.461–4(g)(6)," Reply Brief of Cross Appellant United States at 6—is not fair at all. We decline to take an equivocal sentence ("*appears* to be . . . *similar* to") out of context from a case in which the sole issue was the constitutionality of EPACT and treat it as controlling of the question before us: how EPACT liabilities should be treated for tax deductibility purposes.

The summary judgment for IES on this issue is affirmed.

III.

The judgment of the District Court on IES's claim for a tax refund as a consequence of the ADR trades is reversed and the case is remanded for further proceedings. The judgment of the District Court on the deductibility of IES's EPACT assessments is affirmed. IES's motion to file a supplemental appendix is granted.

State of IDAHO, Plaintiff–Appellant,

v.

Lon T. HORIUCHI, Defendant–Appellee.

No. 98–30149.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted Dec. 20, 2000

Filed June 5, 2001

Federal agent involved in confrontation with suspected weapons trafficker and his associate was charged with involuntary manslaughter after shot which he had fired at retreating suspect struck innocent third party, as she was standing just inside doorway, holding door ajar. Action was removed from state court to the United

H.R. REP. 105-148
H.R. Rep. No. 148, 105TH Cong., 1ST Sess. 1997
P.L. 105-34, *1 TAXPAYER RELIEF ACT OF 1997
HOUSE REPORT NO. 105–148
June 24, 1997
Mr. Kasich, from the Committee on the Budget, submitted the following
R E P O R T
together with
ADDITIONAL AND DISSENTING VIEWS
[To accompany H.R. 2014]

The Committee on the Budget, to whom reconciliation recommendations were submitted pursuant to subsections (b)(2) and (d) of section 105 of House Concurrent Resolution 84, the concurrent resolution on the budget for fiscal year 1998, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

. . .

Impose holding period requirement for claiming foreign tax credits with respect to dividends (sec. 1173 of the bill and new sec. 901(k) of the Code)

Present Law

A U.S. person that receives a dividend from a foreign corporation generally is entitled to a credit for income taxes paid to a foreign government on the dividend, regardless of the U.S. person's holding period for the foreign corporation's stock. A U.S. corporation that receives a dividend from a foreign corporation in which it has a 10-percent or greater voting interest may be entitled to a credit for the foreign taxes paid by the foreign corporation, also without regard to the U.S. shareholder's holding period for the corporation's stock (sections 902 and 960).
As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. shareholders that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on dividends they receive.

Reasons for Change

Although present law imposes a holding period requirement for the dividends-received deduction for a corporate shareholder (sec. 246), there is no similar holding period requirement for foreign tax credits with respect to dividends. As a result, some U.S. persons have engaged in tax-motivated transactions designed to transfer foreign tax credits from persons that are unable to benefit from such credits (such as a tax-exempt entity or a taxpayer whose use of foreign tax credits is prevented by the limitation) to persons that can use such credits. These transactions sometimes involve a short-term transfer of ownership of dividend-paying shares. Other transactions involve the use of derivatives to allow a person that cannot benefit from the foreign tax credits with respect to a dividend to retain the economic benefit of the dividend while another person receives the foreign tax credit benefits.

Explanation of Provision

The bill denies a shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for a minimum period during which it is not protected from risk of loss. Under the bill, the minimum holding period for dividends on common stock is 16 days. The minimum holding period for preferred stock is 46 days.

Where the holding period requirement is not met for stock of a foreign corporation, the bill disallows the foreign tax credits for the foreign withholding taxes that are paid with respect to a dividend. Such credits are denied both to the shareholder and any other taxpayer who would otherwise be entitled to claim foreign tax credits for such withholding taxes (secs. 853, 902 and 960). In addition, the bill applies to all foreign tax credits otherwise allowable for taxes paid by a lower-tier foreign corporation (secs. 902 and 960) and for foreign taxes credits of a RIC that elects to treat its foreign taxes as paid by the shareholders (section 853). The bill denies such credits where any of the stock in the chain of ownership that is a requirement for claiming the credits is held for less than the required holding period.

The bill denies these same foreign tax credit benefits, regardless of the shareholder's holding period for the stock, to the extent that the taxpayer has an obligation to make payments related to the dividend (whether pursuant to a short sale or otherwise) with respect to substantially similar or related property.

The 16- or 46-day holding period under the bill (whichever applies) must be satisfied over a period immediately before or immediately after the shareholder becomes entitled to receive each dividend. For purposes of determining whether the required holding period is met, any period during which the shareholder has protected itself from risk of loss (under the rules of section 246(c)(4)) would not be included. For example, assume a taxpayer buys foreign common stock. Assume also that, the day after stock is purchased, the taxpayer enters into an equity swap under which the taxpayer is entitled to receive payments equal to the losses on the stock, and the taxpayer retains the swap position for the entire period it holds the stock. Under the bill, the taxpayer would not be able to claim any foreign tax credits with respect to dividends on the stock because the taxpayer's holding period is limited to the single day during which the loss on the stock was not protected. The bill provides a special rule that treats a bona fide contract to sell stock as not protecting a stockholder from risk of loss for purposes of the holding period requirement.

The bill provides an exception for foreign tax credits with respect to certain dividends received by active dealers in securities. In order to qualify for the exception, the following requirements must be met (1) the dividend must be received by the entity on stock which it holds in its capacity as a dealer in securities, (2) the entity must be subject to net income taxation on the dividend (on either a residence or worldwide income basis) in a foreign country, and (3) the foreign taxes to which the exception applies must be taxes that are creditable under the foreign country's tax system. A securities dealer for purposes of the exception must be an entity which (1) regularly enters into stock or securities transactions with customers (section 475(c)(1)) and

(2) is registered as a securities dealer under the Securities Exchange Act of 1934 or is licensed or authorized to sell stock to or from customers and subject to bona fide regulation by the securities regulatory authority of the foreign country in which the relevant dividend is subject to net-basis taxation. Under the bill, the Treasury is granted authority to issue regulations necessary or appropriate to prevent abuse of this exception. It is expected that such regulations will provide guidance as to the determination of whether stock is held in a taxpayer's capacity as a dealer or in connection with its securities trading activities.

If a taxpayer is denied foreign tax credits under the bill because the 16- or 46-day holding period requirement is not satisfied, the taxpayer would be entitled to a deduction for the foreign taxes for which the credit is disallowed. This deduction would be available even if the taxpayer claimed the foreign tax credit for other taxes in the same taxable year.

No inference is intended as to the treatment under present law of tax-motivated transactions intended to transfer foreign tax credit benefits.

Effective Date

The provision would be effective for dividends paid or accrued more than 30 days after the date of enactment.

. . .

Ajay Gupta
Financial Products Taxation
Reading #4

OID, Market Discount, and Coupon Stripping

Code: §§ 1271-1278; § 1286.

Regulations: §§ 1.1272-1; 1.1273-1; 1.1274-1, -2; 1.1275-1; 1.1286-1.

Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112 (1940).

Note on OID, Market Discount, and Coupon Stripping (Attached).

Problems:

1. Assume T buys a $1,000 bond, which was originally issued at its face value, for $850. Because the stated redemption price of $1,000 exceeds T's adjusted basis of $850, the bond has market discount of $150. The market discount is allocated ratably over the remaining three-year term. How much of ordinary income would T report if (i) he holds the bond until redemption; and (ii) if he sells the bond for $930 exactly one year after he purchased it? Does it matter what the original term of the bond was?

2. Consider a modern-day Mr. Horst, who purchases from a bank, at par, on original issue, on January 1, Year 1, a five-year coupon bond with a face value of $1,000 and a coupon rate of 10% per annum, the coupons payable semi-annually. In other words, the bond sells for $1,000 on January 1, Year 1, and will make 10 coupon payments of $50 each on July 1 and December 31 of Years 1, 2, 3, 4, and 5, and a balloon payment of $1,000 on December 31, Year 5.

On the date he purchases the bond, *viz.*, January 1, Year 1, and on each January 1 thereafter, until and including January 1, Year 5, Mr. Horst clips the two coupons that will be due later that year, and sells them to his son for those two coupons' then-fair market values of $47.62 and $45.35, respectively. ($50 divided by 1.05 is $47.62, and $50 divided by $(1.05)^2$ is $45.35.) The son holds each coupon until its maturity date, when he takes it to the bank that had issued the bond and collects $50.

In each of the Years 1, 2, 3, 4, and 5:

a. How much interest income is the father required to report?

b. How much interest income is the son required to report?

c. How much interest deduction is the bank allowed to claim?

d. Is there any income shifting that occurs from father to son as a result of this scheme?

(281 U. S. 111)

LUCAS, Commissioner of Internal Revenue, v. EARL.

No. 99.

Argued March 3, 1930.
Decided March 17, 1930.

Internal revenue ⇐7(5)—Husband's entire salary held taxable, notwithstanding agreement with wife that any property acquired by either should be held as joint tenants (Revenue Acts 1918, 1921, §§ 210, 211, 212(a), 213(a).

Although husband and wife had agreed that any property acquired by either should be held by them as joint tenants, husband could be taxed for income tax on whole of salary and attorney's fees earned by him under Revenue Acts 1918, 1921, §§ 210, 211, 212(a), 213(a), 40 Stat. 1062, 1064, 1065, 42 Stat. 233, 237, 238.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

Petition by Guy C. Earl for review of decision of the Board of Tax Appeals sustaining an order of Robert H. Lucas, Commissioner of Internal Revenue, determining that there was a deficiency in income tax paid by the petitioner for the years 1920 and 1921. The decision of the Board of Tax Appeals was reversed [30 F.(2d) 898], and the Commissioner brings certiorari.

Reversed.

The Attorney General and Mr. Charles E. Hughes, Jr., Sol. Gen., of Washington, D. C., for petitioner.

Warren Olney, Jr., of San Francisco, Cal., for respondent.

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*Mr. Justice HOLMES delivered the opinion of the Court.

This case presents the question whether the respondent, Earl, could be taxed for the whole of the salary and attorney's fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife which we shall mention. The Commissioner of Internal Revenue and the Board of Tax Appeals imposed a tax upon the whole, but their decision was reversed by the Circuit Court of Appeals, 30 F.(2d) 898. A writ of certiorari was granted by this court.

By the contract, made in 1901, Earl and his wife agreed "that any property either of us

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now has or may hereafter *acquire * * * in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, and all the proceeds, issues, and profits of any and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship." The validity of the contract is not questioned, and we assume it to be unquestionable under the law of the State of California, in which the parties lived. Nevertheless we are of opinion that the Commissioner and Board of Tax Appeals were right.

The Revenue Act of 1918 approved February 24, 1919, c. 18, §§ 210, 211, 212(a), 213(a), 40 Stat. 1057, 1062, 1064, 1065, imposes a tax upon the net income of every individual including "income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid," § 213(a). The provisions of the Revenue Act of 1921, c. 136, 42 Stat. 227, 233, 237, 238, in sections bearing the same numbers are similar to those of the above. A very forcible argument is presented to the effect that the statute seeks to tax only income beneficially received, and that taking the question more technically the salary and fees became the joint property of Earl and his wife on the very first instant on which they were received. We well might hesitate upon the latter proposition, because however the matter might stand between husband and wife he was the only party to the contracts by which the salary and fees were earned, and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone. But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax

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salaries to those who earned them and *provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Judgment reversed.

The CHIEF JUSTICE took no part in this case.

⇐For other cases see same topic and KEY-NUMBER in all Key-Numbered Digests and Indexes

311 U.S. 112

HELVERING v. HORST.

No. 27.

Argued Oct. 25, 1940.

Decided Nov. 25, 1940.

1. Internal revenue ⇐321

The holder of a coupon bond is the owner of two independent and separable kinds of right, one the right to demand and receive at maturity the principal amount of the bond representing capital investment, and the other the right to demand payment at maturity of interest specified by coupons and the power to command payment to others, which constituted an "economic gain" to him as respects status of coupons as taxable income. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

See Words and Phrases, Permanent Edition, for all other definitions of "Economic Gain".

2. Internal revenue ⇐264, 305

The "realization" of income, rather than the acquisition of the right to receive it, is the taxable event and is not deemed to occur until the income is paid, but not all economic gain of taxpayer is taxable income. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev. Acts, page 669.

See Words and Phrases, Permanent Edition, for all other definitions of "Realization".

3. Internal revenue ⇐265

Receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis, and, where taxpayer does not receive payment of income in money or property, "realization" may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

4. Internal revenue ⇐265, 791

The rule that income is not taxable until "realized" does not mean that taxpayer, even on cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment from his obligor. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

See Words and Phrases, Permanent Edition, for all other definitions of "Realized".

5. Internal revenue ⇐264

The rule that income is not taxable until "realized" is founded on administrative convenience, and is only a rule of postponement of the tax to the final event of "enjoyment" of the income, usually the receipt of it by the taxpayer, and not a rule of exemption from taxation where enjoyment is consummated by some event other than taxpayer's personal receipt of money or property. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

See Words and Phrases, Permanent Edition, for all other definitions of "Enjoyment".

6. Internal revenue ⇐265

Enjoyment of income may be consummated, so as to constitute "realization" of taxable income, when taxpayer has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

7. Internal revenue ⇐196, 305, 791

If taxpayer procures payment directly to his creditors of items of interest or earnings due him, or sets up irrevocable trust with income payable to the objects of his bounty, he does not escape taxation because he did not actually receive the money, since income is "realized" by assignor because he, who owns or controls the source of income, also controls the disposition of that which he could have received himself and diverts payment from himself to others as means of procuring satisfaction of his wants. Revenue Act 1934, §§ 166, 167, 26 U.S.C.A. Int. Rev.Code, §§ 166, 167.

8. Internal revenue ⇐305

A taxpayer has equally enjoyed the fruits of his labor or investment and obtained satisfaction of his desires so as to have "realized" taxable income, whether he collects and uses the income to procure those

satisfactions, or disposes of his right to collect it as the means of procuring them. Revenue Act 1934, §§ 166, 167, 26 U.S.C.A. Int.Rev.Code §§ 166, 167.

9. Internal revenue ⇐305, 791

Where father, who reported income on cash receipts basis, detached negotiable interest coupons from bonds shortly before their due date and gave them to his son, who in the same year collected them at maturity, enjoyment of the economic benefit from the coupons was "realized" by father as completely as if he had collected the interest in dollars and expended them, and hence the interest payments were taxable to father in the years when paid. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

10. Internal revenue ⇐121

Common understanding and experience are the touchstones for the interpretation of the revenue laws. Revenue Act 1934, §§ 166, 167, 26 U.S.C.A. Int.Rev.Code §§ 166, 167; Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

11. Internal revenue ⇐305

The power to dispose of income is the equivalent of "ownership" and the exercise of that power to procure the payment of income to another is the "enjoyment", and hence the "realization" of the income by him who exercises it, so as to render the income subject to tax. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

See Words and Phrases, Permanent Edition, for all other definitions of "Ownership".

12. Internal revenue ⇐232

The dominant purpose of the revenue laws is the taxation of income of those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev. Acts, page 669.

13. Internal revenue ⇐265, 305

The tax laid upon income "derived from * * * wages, or compensation for personal services, of whatever kind and in whatever form paid * * *; also from interest", cannot be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received. Revenue Acts 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

See Words and Phrases, Permanent Edition, for all other definitions of "Derived from Wages, or Compensation for Personal Services, of Whatever Kind and in Whatever Form Paid; also, from Interest".

14. Internal revenue ⇐793

The statute defining "income" for purposes of taxation affords no basis for distinguishing, as respects taxability of income to assignor of right to compensation, between cases where the right to compensation vests instantaneously in assignor when paid, though assignor never receives it, and cases where such right antedates the assignment and thus precludes instantaneous vesting. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

See Words and Phrases, Permanent Edition, for all other definitions of "Income".

15. Internal revenue ⇐193

The purpose of statute defining "income" for purposes of taxation cannot be escaped by anticipatory arrangements, however skillfully devised, to prevent income from vesting even for a second in donor of the income. Revenue Act 1934, § 22, 26 U.S.C.A. Int.Rev.Acts, page 669.

Mr. Justice McREYNOLDS, Mr. Chief Justice HUGHES, and Mr. Justice ROBERTS dissenting.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Petition by Paul R. G. Horst to review a decision of the Board of Tax Appeals determining deficiencies in income tax imposed by the Commissioner of Internal Revenue for the years 1934 and 1935. To review a judgment of the Circuit Court of Appeals, 107 F.2d 906, reversing the decision of the Board of Tax Appeals,

Guy T. Helvering, Commissioner of Internal Revenue, brings certiorari.

Reversed.

Messrs. Robert H. Jackson, Atty. Gen., and Arnold Raum, of Washington, D. C., for petitioner.

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Mr. Selden Bacon, of New York City, for respondent.

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Mr. Justice STONE delivered the opinion of the Court.

The sole question for decision is whether the gift, during the donor's taxable year, of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, is the realization of income taxable to the donor.

In 1934 and 1935 respondent, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son who in the same year collected them at maturity. The Commissioner ruled that under the applicable § 22 of the Revenue Act of 1934, 48 Stat. 680, 686, 26 U.S.C.A.Int.Rev.Acts, page 669, the interest payments were taxable, in the years when paid, to the respondent donor who reported his income on the cash receipts basis. The circuit court of appeals reversed the order of the Board of Tax Appeals sustaining the tax. 2 Cir., 107 F.2d 906; 39 B.T.A. 757. We granted certiorari, 309 U.S. 650, 60 S.Ct. 807, 84 L.Ed. 1001, because of the importance of the question in the administration of the revenue laws and because of an asserted conflict in principle of the decision below with that of Lucas v. Earl, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731, and with that of decisions by other circuit courts of appeals. See Bishop v. Commissioner, 7 Cir., 54 F.2d 298; Dickey v. Burnet, 8 Cir., 56 F.2d 917, 921; Van Meter v. Commissioner, 8 Cir., 61 F.2d 817.

The court below thought that as the consideration for the coupons had passed to the obligor, the donor had, by the gift, parted with all control over them and their payment, and for that reason the case was distinguishable

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from Lucas v. Earl, supra and Burnet v. Leininger, 285 U.S. 136, 52 S.Ct. 345, 76 L.Ed. 665, where the assignment of compensation for services had preceded the rendition of the services, and where the income was held taxable to the donor.

[1] The holder of a coupon bond is the owner of two independent and separable kinds of right. One is the right to demand and receive at maturity the principal amount of the bond representing capital investment. The other is the right to demand and receive interim payments of interest on the investment in the amounts and on the dates specified by the coupons. Together they are an obligation to pay principal and interest given in exchange for money or property which was presumably the consideration for the obligation of the bond. Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others which constituted an economic gain to him.

[2, 3] Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining "realization" of income as the taxable event rather than the acquisition of the right to receive it. And "realization" is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him. Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 49 S.Ct. 499, 73 L.Ed. 918; Corliss v. Bowers, 281 U.S. 376, 378, 50 S.Ct. 336, 74 L.Ed. 916. Cf. Burnet v. Wells, 289 U.S. 670, 53 S.Ct. 761, 77 L.Ed. 1439.

[4-7] In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment

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accrued. But the rule that income is not taxable until realized has

never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. Cf. Aluminum Castings Co. v. Routzahn, 282 U.S. 92, 98, 51 S.Ct. 11, 13, 75 L.Ed. 234. This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth. The question here is, whether because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment. If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him, see Old Colony Trust Co. v. Commissioner, supra; Bowers v. Kerbaugh-Empire Co., 271 U.S. 170, 46 S.Ct. 449, 70 L.Ed. 886; United States v. Kirby Lumber Co., 284 U.S. 1, 52 S.Ct. 4, 76 L.Ed. 131, or if he sets up a revocable trust with income payable to the objects of his bounty, §§ 166, 167, Revenue Act of 1934, 26 U.S.C.A. Int.Rev.Code, §§ 166, 167, Corliss v. Bowers, supra; cf. Dickey v. Burnet, 8 Cir., 56 F.2d 917, 921, he does not escape taxation because he did not actually receive the money. Cf. Douglas v. Willcuts, 296 U.S. 1, 56 S.Ct. 59, 80 L.Ed. 3, 101 A.L.R. 391; Helvering v. Clifford, 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788.

[8] Underlying the reasoning in these cases is the thought that income is "realized" by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have

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received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. Cf. Burnet v. Wells, supra.

[9] Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself he has nevertheless, by his act, procured payment of the interest, as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives the money he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named. Burnet v. Wells, supra.

[10] In a real sense he has enjoyed compensation for money loaned or services rendered and not any the less so because it is his only reward for them. To say that one who has made a gift thus derived from interest or earnings paid to his donee has never enjoyed or realized the fruits of his investment or labor because he has assigned

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them instead of collecting them himself and then paying them over to the donee, is to affront common understanding and to deny the facts of common experience. Common understanding and experience are the touchstones for the interpretation of the revenue laws.

[11] The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment

and hence the realization of the income by him who exercises it. We have had no difficulty in applying that proposition where the assignment preceded the rendition of the services, Lucas v. Earl, supra; Burnet v. Leininger, supra, for it was recognized in the Leininger case that in such a case the rendition of the service by the assignor was the means by which the income was controlled by the donor and of making his assignment effective. But it is the assignment by which the disposition of income is controlled when the service precedes the assignment and in both cases it is the exercise of the power of disposition of the interest or compensation with the resulting payment to the donee which is the enjoyment by the donor of income derived from them.

This was emphasized in Blair v. Commissioner, 300 U.S. 5, 57 S.Ct. 330, 81 L.Ed. 465, on which respondent relies, where the distinction was taken between a gift of income derived from an obligation to pay compensation and a gift of income-producing property. In the circumstances of that case the right to income from the trust property was thought to be so identified with the equitable ownership of the property from which alone the beneficiary derived his right to receive the income and his power to command disposition of it that a gift of the income by the beneficiary became effective only as a gift of his ownership of the property producing it. Since the gift was deemed to be a gift of the property the income from it was held to be the income of the owner of the property,

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who was the donee, not the donor, a refinement which was unnecessary if respondent's contention here is right, but one clearly inapplicable to gifts of interest or wages. Unlike income thus derived from an obligation to pay interest or compensation, the income of the trust was regarded as no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm had been given away. Blair v. Commissioner, supra, 300 U.S. 12, 13, 57 S.Ct. 333, 81 L.Ed. 465 and cases cited. See also Reinecke v. Smith, 289 U.S. 172, 177, 53 S.Ct. 570, 572, 77 L.Ed. 1109. We have held without deviation that where the donor retains control of the trust property the income is taxable to him although paid to the donee. Corliss v. Bowers, supra. Cf. Helvering v. Clifford, supra.

[12, 13] The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. See, Corliss v. Bowers, supra, 281 U.S. 378, 50 S.Ct. 336, 74 L.Ed. 916; Burnet v. Guggenheim, 288 U.S. 280, 283, 53 S.Ct. 369, 370, 77 L.Ed. 748. The tax laid by the 1934 Revenue Act upon income "derived from * * * wages, or compensation for personal service, of whatever kind and in whatever form paid * * *; also from interest * * *" therefore cannot fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received.

[14, 15] It is the statute which taxes the income to the donor although paid to his donee. Lucas v. Earl, supra; Burnet v. Leininger, supra. True, in those cases the service which created the right to income followed the assignment and it was arguable that in point of legal theory the right to the compensation vested instantaneously in the assignor when paid although he never received it; while here the right of the assignor to receive the income

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antedated the assignment which transferred the right and thus precluded such an instantaneous vesting. But the statute affords no basis for such "attenuated subtleties." The distinction was explicitly rejected as the basis of decision in Lucas v. Earl. It should be rejected here, for no more than in the Earl case can the purpose of the statute to tax the income to him who earns, or creates and enjoys it be escaped by "anticipatory arrangements * * * however skilfully devised" to prevent the income from vesting even for a second in the donor.

Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions. The owner of a negotiable bond and of the investment which it represents, if not the lender, stands in the place of the lender. When, by the gift of the coupons, he has separated

his right to interest payments from his investment and procured the payment of the interest to his donee, he has enjoyed the economic benefits of the income in the same manner and to the same extent as though the transfer were of earnings and in both cases the import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew. See Lucas v. Earl, supra, 281 U.S. 115, 50 S.Ct. 241, 74 L.Ed. 731.

Reversed.

The separate opinion of Mr. Justice McREYNOLDS.

The facts were stipulated. In the opinion of the court below [107 F.2d 907], the issues are thus adequately stated: "The petitioner owned a number of coupon bonds. The coupons represented the interest on the bonds and were payable to bearer. In 1934 he detached unmatured coupons of face value of $25,182.50 and transferred them by manual delivery to his son as a gift. The coupons matured later on in the same year, and the son collected the face amount, $25,182.50, as his own property. There

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was a similar transaction in 1935. The petitioner kept his books on a cash basis. He did not include any part of the moneys collected on the coupons in his income tax returns for these two years. The son included them in his returns. The Commissioner added the moneys collected on the coupons to the petitioner's taxable income and determined a tax deficiency for each year. The Board of Tax Appeals, three members dissenting, sustained the Commissioner, holding that the amounts collected on the coupons were taxable as income to the petitioner." The decision of the Board of Tax Appeals was reversed and properly so, I think.

The unmatured coupons given to the son were independent negotiable instruments, complete in themselves. Through the gift they became at once the absolute property of the donee, free from the donor's control and in no way dependent upon ownership of the bonds. No question of actual fraud or purpose to defraud the revenue is presented.

Neither Lucas v. Earl, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731, nor Burnet v. Leininger, 285 U.S. 136, 52 S.Ct. 345, 76 L.Ed. 665, support petitioner's view. Blair v. Commissioner, 300 U.S. 5, 11, 12, 57 S.Ct. 330, 332, 333, 81 L.Ed. 465, shows that neither involved an unrestricted completed transfer of property.

Helvering v. Clifford, 309 U.S. 331, 335, 336, 60 S.Ct. 554, 556, 557, 84 L.Ed. 788, decided after the opinion below, is much relied upon by petitioner, but involved facts very different from those now before us. There no separate thing was absolutely transferred and put beyond possible control by the transferror. The court affirmed that Clifford, both conveyor and trustee, "retained the substance of full enjoyment of all the rights which previously he had in the property." "In substance his control over the corpus was in all essential respects the same after the trust was created, as before." "With that control in his hands he would keep direct

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command over all that he needed to remain in substantially the same financial situation as before."

The general principles approved in Blair v. Commissioner, 300 U.S. 5, 57 S.Ct. 330, 81 L.Ed. 465, are applicable and controlling. The challenged judgment should be affirmed.

The CHIEF JUSTICE and Mr. Justice ROBERTS concur in this opinion.

311 U.S. 122

HELVERING, Com'r of Internal Revenue, v. EUBANK.

No. 205.

Argued Oct. 25, 1940.

Decided Nov. 25, 1940.

Rehearing Denied Feb. 3, 1941.

See 312 U.S. 713, 61 S.Ct. 609, 85 L.Ed. —.

Internal revenue ⇐793

Where general life insurance agent who made income tax returns on cash basis, after termination of his agency contracts and services as agent, made assignments of renewal commissions to become payable subsequently, without other apparent purpose than to confer on assignees the power to collect commissions, which they did in par-

ECONOMIC ACCRUAL OF INTEREST AND ORIGINAL ISSUE DISCOUNT

Thus far, we have been examining the treatment of so-called "stated interest," *i.e.*, interest delineated as such by the parties to a transaction. However, not all transactions are clearly defined; interest that is actually charged may not be termed interest but may, instead, be disguised by calling it something else. Consider the following example: A borrows $10,000 from B for 5 years; A agrees to pay B $12,000 at the end of the loan term. Two thousand dollars of A's payment to B is clearly interest, despite the fact that the parties to the loan transaction did not label it as such. Because taxpayers seeking to deduct interest and others seeking to avoid its inclusion have been known to manipulate the interest component of a transaction, the tax law has developed a series of mechanisms to identify the interest portion of transactions such as A and B's. Once the interest component is identified, the question shifts to the timing of the interest income and the interest deduction (if allowed).

Since 1982, the Code has developed time value of money rules that require the accrual of interest income and deductions in an economically accurate manner over the loan term, regardless of the taxpayer's method of accounting. For example, if an individual deposits and leaves $100,000 in a bank account, and the bank account pays 10% interest on the account annually, how much will be in the account at the end of three years? If the bank pays compounded interest, as is typical, interest is earned on the original $100,000 principal, and also on any previously earned interest left on deposit. The interest earned each year is added to the deposit balance and subsequently earns interest during each succeeding year. Thus, the amount of interest earned each year increases, *i.e.*, compounds, since the amount on deposit increases each year. In this example, if the $100,000 yields 10% interest compounded annually, at the end of three years, there will be a total of $133,100 in the account. The account would grow as follows:

Table 1

	Beginning Amount on Deposit		Interest Factor		Interest Earned at End of Year
Year 1:	$100,000	×	0.1	=	$10,000
Year 2:	110,000	×	0.1	=	11,000
Year 3:	121,000	×	0.1	=	12,100
Year 3:	121,000	×	0.1	=	12,100
Year 4:	133,100				

Although interest may be compounded annually, quarterly, or on any other basis, the Code's default rule is semiannual compounding. This means that the interest accrual period is 6 months and that the interest accrual calculation is performed every 6 months, rather than once a year. Thus, if the interest rate is 10% compounded semiannually, the account grows at half that rate, or 5%, every 6 months. Because the balance on deposit grows more rapidly, the interest earned is larger. The shorter the compounding period, the more total interest accrues. If the bank paid interest at the rate of 10% compounded semiannually, at the end of the three years the initial $100,000 bank deposit in our example would grow to $134,009.57. The account would grow as follows:

Table 2

Jan. 1 Year 1, 1st Accrual Period	$100,000.00	0.05	$5,000.00
July 1 Year 1, 2nd Accrual Period	105,000.00	0.05	5,250.00
Jan. 1 Year 2, 3rd Accrual Period	110,250.00	0.05	5,512.50
July 1 Year 2, 4th Accrual Period	115,762.50	0.05	5,788.13
Jan. 1 Year 3, 5th Accrual Period	121,550.63	0.05	6,077.53
July 1 Year 3, 6th Accrual Period	127,628.16	0.05	6,381.41
Dec. 31 of Year 3			$134,009.57

1.ORIGINAL ISSUE DISCOUNT

In 1982, after struggling for more than 30 years with the treatment of debt instruments given in consideration for the sale of property or for cash, Congress finally adopted a comprehensive and complex set of rules for identifying interest and timing its inclusion and deduction. Congress gradually realized that if the tax reporting of a transaction does not conform to the economic or financial realities of that transaction, substantial distortions will result.

Before studying the rules currently in force, it is helpful to examine some of the distortions caused by past tax accounting practices. Those practices sometimes conflicted with economic realities, the determination of interest charged, and the period to which the interest related. At the same time, we examine some of the prior legislative responses to these distortions.

a.Introduction: Debt Instruments Issued for Cash Prior to 1982

Prior to 1954, the Internal Revenue Code contained no provision addressing disguised or understated interest. This omission encouraged purchasers of corporate bonds with unstated interest to treat the interest earned on their bonds as capital gains eligible for preferential treatment. For example, if a corporation needed to borrow $100,000 at 10% interest compounded semiannually, it could issue a non-interest bearing bond with a face amount of $134,009.57, the amount payable at the end of three years. The issuing corporation would receive $100,000 in cash for its bond. (This is commonly referred to as a zero-coupon bond and the difference of $34,009.57 is OID. As can be seen from Table 2 above, the amount of the discount, the difference between the $100,000 issue price and the $134,009.57 redemption price, represents $34,009.57 of compound interest earned over three years. However, at redemption, the bondholder maintained that the entire amount of this interest income was capital gain. And, if she used the cash method of accounting, she did not have to report this gain until the year the corporation retired the bond. In 1954 Congress enacted legislation requiring that OID be treated as ordinary income. In United States v. Midland-Ross Corp.,[15] the Supreme Court recognized that "[e]arned original issue discount serves the same function as stated interest, . . . it is simply 'compensation for the use or forbearance of money.' " The Court held that "earned original issue is not entitled to capital gains treatment."

In 1954, Congress was concerned only with characterizing OID as interest. It did not focus on the timing and allocation of the interest element. As a result, two distortions continued. First, there was a lack of timing symmetry between the typical cash method individual bondholder

(lender) and the typical accrual method issuer corporation (borrower). The accrual method corporation deducted as interest expense a portion of the total unstated interest each year, while the cash method individual bondholder did not report the interest income until she received it, the year the bond was redeemed or sold.

Second, the corporation and the bondholder computed the interest allocable to each year the bond was outstanding as a level, ratable percentage of the total OID. Using Table 2, the $34,009.57 of OID would be divided by the 3-year term of the bond. Thus, $11,336.52 would be deducted by the corporation annually. This allowed an artificial acceleration of the interest to the early years of the loan. As Table 2 indicates, annual compound interest is smaller than this level amount for the first year. In fact, allocating interest ratably over the loan period can vastly overstate the interest component in the early years of a loan and bears no correlation to how interest actually accrues over time. The amount of interest that accrues on an OID obligation is a function of a constant rate of interest applied to the outstanding loan balance. The loan balance includes the original principal and accrued but unpaid interest and increases as the amount of accrued, unpaid interest grows over time. Looking at Table 2, we see how interest accrues economically, starting small and becoming larger as the interest and loan principal remain outstanding.

In 1969, Congress dealt with the timing symmetry issue: it amended the OID provisions to provide for mandatory annual inclusion of the OID, so that the bondholder annually reported the same amount of interest income that the corporation annually deducted as interest. In effect, cash method bondholders were put on a type of accrual method for OID bonds. Although symmetry was achieved, a significant distortion remained, because the amount of annual interest reported and deducted was still the ratable, level amount which failed to reflect the compounding effect of unpaid interest. Despite the distortion, Congress allowed ratable, level reporting of interest on the assumption that the counterparties to a loan transaction would have conflicting interests; what the government would lose on the amount of deduction taken by the issuer, it would make up on the amount of income reported by the bondholder. These assumptions break down when the bondholders are pension funds or other tax-exempt institutions indifferent to the front-loading of their interest income. As more fully discussed by Congress below, by failing to deal with the economic accrual of interest, the 1969 rules could lead to egregious results. For example, assume a corporation issued a $10,000,000 zero coupon bond due in 30 years for $120,000 in cash so as to yield 15% compounded annually. The corporation could deduct $329,333 a year as interest (1/30 × $9,880,000) when in reality its interest expense for the first year was only $18,000 (15% × $120,000). If the bondholder did not pay taxes on its income, it did not care that its income for the early years was overstated.

In 1982, Congress added §§ 163(e) and 1232A (a precursor to what is now § 1272(a)) to the Code, requiring the economic accrual of interest for both the issuer (borrower) and the holder (lender) of a debt instrument issued for cash. Interest must be allocated over the loan period as it accrues economically. Accordingly, both parties, in our example, would accrue only $18,000 as interest in the first year.

Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982

160–163 (1983).

Reasons for Change

The larger deductions allowed to issuers of OID bonds in the early years of a bond's term relative to deductions allowed issuers of interest-bearing bonds not issued at a discount were a substantial tax advantage to the former, an advantage that increased with the term of the bonds.

The ratable OID amortization formula was adopted at a time when interest rates were considerably lower than at present and when the formula involved a much smaller distortion. The formula was significantly different from the formula which issuers use to compute interest deductions on financial statements and did not represent a proper measurement of interest costs to the issuer. There was no justification for providing what was, in effect, a tax incentive for issuing long-term OID bonds.

Moreover, the larger income inclusion for OID bond purchasers in early years, relative to purchasers of non-discount bonds, unjustifiably penalized those who wished to take advantage of the opportunity the OID bond provides to guarantee the reinvestment of the interest payments at the bond's initial yield to maturity. Under prior law, only tax-exempt [holders], such as pension funds, could avoid this penalty.

Congress also believed that the treatment of holders of OID bonds should be comparable, whether the bonds are corporate or non-corporate obligations, and that the treatment of taxable, non-corporate issuers of OID bonds should be comparable to the treatment of corporate issuers.

Explanation of Provision

The Act provides new rules for computing the method of amortizing original issue discount, using a method that parallels the manner in which interest would accrue through borrowing with interest-paying, non-discount bonds.

Under the formula prescribed in the Act, the OID is allocated over the life of the bond through a series of adjustments to the issue price for each "bond period." The adjustment to the issue price for any bond period is determined by multiplying the adjusted issue price (*i.e.*, the issue price as increased by adjustments prior to the beginning of the bond period) by the bond's yield to maturity and then by subtracting the interest payable during the bond period. The adjustment to the issue price for any bond period is the amount of the OID allocated to that bond period.

Except as regulations may provide otherwise, a bond period for any given bond is each one-year period beginning on the date of issue of the bond and each anniversary thereof, or the shorter period to maturity for the last bond period. The increase in the adjusted issue price for any bond period is allocated ratably to each day in the bond period.

Each bondholder must include in income the sum of the daily portions of OID so determined for each day during the taxable year the bond is held. When the taxable year of a holder overlaps more than one bond period (which will generally be the case unless the bond period happens to coincide with the holder's taxable year), the holder must include the appropriate daily portions for each of the relevant bond periods. The daily portions of OID includible in income or deductible will be reflected in the current earnings and profits of corporate bondholders and issuers.

* * *

As under prior law, the basis of a bond will be increased for the OID included in income.

* * *

The aggregate daily portions of OID determined under the new rules that accrue during the taxable year of the issuer are the amount that the issuer may deduct * * *. The deduction for OID will apply to all issuers of OID obligations (other than natural persons) regardless of whether the issuer uses the cash or the accrual method of accounting.

Although the 1982 legislation finally required both the bondholder and the corporation to report and deduct interest equivalents on an economically realistic basis, these requirements

applied only to those debt instruments governed by the OID rules. Many common debt instruments were excluded from the OID rules, but are now covered by the rules through later amendments.

b.Current Treatment of Original Issue Discount: Debt Instruments Issued for Cash

Current provisions governing the treatment of OID are found in §§ 1271–1278. For debt instruments issued for cash, the Code requires the holder (lender) to include accrued OID in income. § 1272. To the extent that the holder includes OID, the holder's basis in the obligation is increased, and the issuer (borrower) is entitled to a deduction. § 163(e).

The Holder. Technically, the holder of any debt instrument (defined in § 1275(a)(1)) having original issue discount is required to include in gross income an amount equal to the "sum of the daily portions" of the OID "for each day during the taxable year on which such holder held such debt instrument." § 1272(a)(1). A few definitions are required before the taxpayer can calculate the annual OID inclusion.

The *original issue discount* equals the excess of the obligation's stated redemption price at maturity minus its issue price. § 1273(a)(1). For example, if the investor purchased a bond for $750, bearing no interest, with a stated redemption price of $1,000 at maturity, the original issue discount equals $250.

The *stated redemption price at maturity* equals the amount fixed for payment at maturity and includes interest and other amounts payable at the maturity date. § 1273(a)(2). However, the stated redemption price at maturity excludes the amount paid at maturity that constitutes interest based on a fixed rate which is payable unconditionally at specified, fixed periodic intervals of one year or less during the entire term of the instrument. For example, the holder purchases a 5-year bond for $500 bearing 10% interest that is paid annually. Each year, the bondholder receives $50 of interest. At the end of Year 5, the bondholder is paid $500 principal plus $50 for Year 5's interest. The stated redemption price is $500 and there is no OID. On the other hand, if interest is accrued but not paid until maturity, it is included in the stated redemption price. A single debt instrument may have both periodic interest payments and interest that is paid at maturity. If the bond in the example paid $700 at maturity, it would be such an investment and would have $200 of OID.

The term *issue price* is defined in § 1273(b). For publicly offered debt instruments that are issued for cash, the issue price equals the initial offering price at which price a "substantial amount" of instruments were sold. § 1273(b)(1). For debt instruments that are neither issued for property nor publicly offered, such as a private loan obligation, the issue price equals the price paid by the first buyer of such instrument regardless of the price paid by other purchasers. § 1273(b)(2). The issue price of an obligation issued for property is defined in § 1273(b)(3) and § 1274. We shall examine the treatment of debt instruments issued for property in the next assignment.

There is a de minimis exception to the OID rules. The OID is not included in gross income, but is deductible, if such discount is less than 0.25% of the stated redemption price at maturity multiplied by the number of full years to maturity. §§ 163(e)(2)(B) and 1273(a)(3).

The holder must include in gross income the sum of the daily portions of the original issue discount for each day of the taxable year in which she holds the bonds. § 1272(a)(1). To determine the daily portion of the instrument's OID, the taxpayer allocates to each day in any accrual period her ratable portion of the increase of the adjusted issue price of the bond during that accrual period. § 1272(a)(3). This computation relies on the following terms: (1) accrual period; (2) adjusted issue price; (3) increase in the adjusted issue price; and (4) yield to maturity.

The *accrual period* is the compounding period used to determine the amount of original issue discount included in income. An accrual period may be no longer than one year, and each scheduled principal or interest payment must occur at the end of an accrual period. Computation of OID is simplest if the accrual period corresponds to payment dates provided by the debt instrument's terms. *See* § 1272(a)(5) and Reg. § 1.1272–1(b)(1)(ii). For example, a bond issued on January 1, 2019, and maturing on December 31, 2020, requires the payment of periodic interest every six months and therefore has the following accrual periods: (1) January 1, 2019 to June 30, 2019; (2) July 1, 2019 to December 31, 2019; (3) January 1, 2020 to June 30, 2020; and (4) July 1, 2020 to December 31, 2020. Accrual periods may vary in length over the term of the debt instrument.

After determining the accrual periods falling within a tax year and the number of days in each accrual period that the holder held the instrument, the taxpayer must determine the adjusted issue price of the instrument at the beginning of each accrual period, if the tax year includes more than one accrual period. The *adjusted issue price* for any debt instrument at the beginning of any accrual period equals the sum of the instrument's issue price plus any amount of original issue discount previously included in the income of any holder since the issue date. § 1272(a)(4). The adjusted issue price may be viewed as the outstanding loan amount at a particular point in time, *i.e.*, the original principal plus previously accrued but unpaid interest. At the beginning of the first accrual period, the adjusted issue price is the original issue price or loan proceeds.

The *increase in the adjusted issue price* for any accrual period is an amount equal to the excess (if any) of: (1) the product of the adjusted issue price of the bond at the beginning of the accrual period and the bond's *yield to maturity*, less, (2) any interest payable on the bond during the accrual period. § 1272(a)(3). The yield to maturity is a bond's implicit interest rate. It may be stated as the discount rate, which when used to compute the present value of all interest and principal payments to be made under the debt instrument, produces as a present value, the issue price. *See* Reg. § 1.1272–1(b)(1)(i). The yield must be constant over the term of the debt instrument. Hence this is referred to as the constant yield method. The amount of original issue discount for each accrual period is then added to the adjusted issue price at the beginning of that period to arrive at the adjusted issue price at the beginning of the next accrual period.

c.Lapses in the Identification of Interest

Despite these rules, distortions do continue from the failure to identify the interest component of other transactions that do not produce OID. Sophisticated taxpayers will take advantage of the inconsistent treatment of various loan equivalents as long as the Code fails to identify interest and tax it as such in every transaction in which the time value of money is relevant to the economic arrangement of the parties. For example, consider the taxpayer who is entitled to a 5% discount if she pays for trade supplies within 10 days of delivery, rather than waiting the 60 days until payment is due. The payment in 60 days includes a 5% charge for interest on credit extended from the seller to the buyer, but it is not identified as interest and is not subject to the OID rules.

For a slightly more complex example, consider a forward contract: T may pay $175 today for property to be delivered by O (Owner) in two years. The seller is rewarding T in the form of a lower purchase price for the use of T's money for two years. Current law does not impute any interest in this transaction. Also, consider the taxpayer who purchases an option to acquire property: T pays O $50 for an option entitling T to purchase property owned by O for its current fair market value, $125, at any time during the next 8 years. In essence, O is rewarding T, by keeping the purchase price constant, for allowing O to use T's $50, until T decides whether to exercise the option or not. However, under current law, no interest is identified as part of the

transaction. T has no taxable income until he sells the option, lets it lapse, or disposes of O's property obtained through exercise of the option. If the option is exercised, T is simply viewed as purchasing O's property, and the $50 option payment is added to the $125 exercise price giving T a total basis for the property of $175. If the option is not exercised, T has a $50 capital loss equal to the price he paid for the option. Alternatively, if T sells the option for cash, then T has a gain or loss, measured by the difference between the amount received and the $50 paid for the option. T and O are treated consistently under current law, so O has no income on selling the option, nor is O entitled to any interest deduction. If T exercises the option, then O has gain or loss, which may be capital, based on the difference between O's basis in the property and the sum of the option and exercise price, $175. If the option lapses, O has a $50 short term capital gain. If O pays T for the option, *i.e.*, cash settles, O has gain or loss, equal to the difference between the amount he pays T and the amount he received from T for the option. *See* §§ 1234, 1234A.

2.DEBT INSTRUMENTS PURCHASED AT A PREMIUM: AMORTIZATION OF PREMIUM

Bond premium is the opposite of bond discount. Thus, a taxpayer pays a premium when he purchases a bond for more than the amount that will be paid at maturity. This occurs when an instrument pays interest at a rate that exceeds the prevailing market rate. For example, a 6 year $1,000 bond yielding 10% ($100 per year) may sell for $1,100, if market rates decline to 8½% in Year 2. The extra $100 over the stated redemption price is bond premium. Section 171 allows this purchaser to elect to amortize the $100 premium and deduct it over the life of the bond. § 171(c)(1). The premium is included in the taxpayer's basis for the bond, and deductions for amortized bond premium reduce the holder's adjusted basis in the bond. §§ 171(a)(3) and 1016(a)(5); Reg. § 1.171–1(a)(2). Thus, if the bond is held to maturity, all of the premium will be recovered through amortization deductions and there will be no loss at redemption. The effect of the amortization deduction is to decrease current ordinary income and, in the case of redemption, eliminate a future capital loss. Any unamortized premium remains in basis, decreasing gain or increasing loss on a sale or other disposition.

The amount of bond premium that can be amortized for a taxable year is calculated under the constant yield method. As we discussed in connection with OID, under the constant yield method, amortizable bond premium is computed on the basis of the taxpayer's yield to maturity using the taxpayer's basis for the bond and compounding at the close of each accrual period. § 171(b)(3). An accrual period is generally a six-month period ending on the date that corresponds to the maturity date of the bond or the date that is six months before the maturity date. § 1272(a)(5). *See* Reg. § 1.1272–1(b)(1)(ii).

3.MARKET DISCOUNT BONDS

OID bonds are designed by the borrower to pay a greater amount at maturity than was raised at issue. But bondholders may be entitled to more at maturity than they paid for a bond even if the bond has no original discount. Assume that an individual purchases a corporate bond in the market for $990 on January 1 of Year 25. The bond was originally issued in Year 1 with a $1,000 face amount; it pays $89 of annual interest at year end and it matures on December 31 of Year 25. The bond sold at a discount from its face because market interest rates on January 1 of Year 25 were higher than the bond's stated 8.9% return. The $10 difference between the stated redemption price ($1,000) and the purchaser's $990 cost is called market discount. § 1278(a). The purchaser is looking for a 10% return on his $990 investment, or $99. Since the purchaser will receive an interest payment of $89 and $10 of gain when the bond is redeemed for $1,000, his yield to maturity is 10%. (Of course, market discount may reflect not only changes in market rates but other factors, such as a change in the issuer's credit worthiness.)

Section 1276 recognizes that market discount is another substitute for stated interest. It provides that gain on the disposition of a "market discount bond," defined in § 1278(a)(1) and (a)(3), is treated as interest to the extent of the accrued "market discount," defined in § 1278(a)(2).

Although financial accuracy would require the holder of a market discount bond to annually accrue the discount over the remaining term of the bond, for administrative reasons, the Code permits the holder to defer reporting market discount income until the year of the bond's disposition. § 1276(a)(1). However, a taxpayer may elect to report the market discount income as it accrues. § 1278(b).

Any gain on the sale or other disposition of a market discount bond is ordinary income to the extent that such gain does not exceed the market discount accrued on the bond to the date of disposition. § 1276(a)(1). Accrued market discount is computed ratably (straight line) and equals an amount that bears the same ratio to the market discount on the bond as the number of days the investor held the bond bears to the number of days the investor could have held the bond had he held to maturity. § 1276(b)(1). Assuming the bond is a capital asset, any gain in excess of the accrued market discount is capital gain.

Consider the following example. On July 1 of Year 1, T purchases, for $9000, a $10,000 bond bearing 9% stated interest which will mature in ten years. The bond was originally issued at face value. The amount of the market discount equals $1,000. On June 30 of Year 3, T sells the bond for $9,600. Of the $600 gain, $200 is accrued market discount taxed as ordinary income ($1,000 × 730 days/3650 days). The remaining $400 is long-term capital gain.

4.COUPON STRIPPING

Typically, when a seller disposes of an asset, such as a bond, she sells both the underlying property and its future income stream, and thus disposes of her entire interest. Assuming the bond is a capital asset, any gain on the sale is treated as capital and not interest. The taxpayer has actually sold two separable property rights: the coupons—which represent the right to interest payments until maturity, and the bond itself—which represents the right to the face amount of the bond at the maturity date. But the taxpayer is treated as having disposed of only one thing.

Economically, it is possible to value the separate components. If T purchases a $10,000 bond at its issue date for $10,000, maturing in 12 years with coupons that provide $500 every 6 months for each of the next 12 years (10% interest), and market rates of interest are 10%, the present value of the coupons (an annuity of $500 every 6 months for 12 years) is $6,900. The present value of the bond without the coupons (the right to receive a payment of $10,000 in 12 years) is $3,100. Together, the present value of the coupons and the bond equals $10,000.

While T holds the bonds and coupons, the entire $10,000 basis is allocated to the bond and none to the coupons. Consequently, upon receipt of each $500 interest payment, the entire amount is reported as ordinary interest income, and the entire $10,000 of redemption proceeds is treated as a return of basis. But if ownership of the coupons and bonds is separated, then basis is allocated among the separable items. If the owner keeps the coupons and sells the stripped bond (a bond without the coupons) for $3,100 (its fair market value), she may not report a $6,900 capital loss (as she could, if none of the basis was allocated to the coupons). Under § 1286, she will have no gain or loss.

Section 1286 applies to a disposition (by sale or by gift) that produces a separation of ownership between the bond and its coupons. Under § 1286, the owner of a bond with coupons must allocate her basis between the coupons and the stripped bond any time the coupons and the bond are separated. § 1286(b)(3). In our illustration, the seller of the stripped bond could allocate

only $3,100 of her $10,000 basis to the stripped bond. The remaining basis stays with the coupons, and a portion of each coupon payment is treated as a return of basis.

The purchaser of a stripped bond is treated as having acquired a bond issued with OID. The OID allocable to the bond is the excess, if any, of the stated redemption price at maturity over the purchase price allocable to the stripped bond. § 1286(a). *See also*§ 1286(e)(4). Continuing with our illustration, if the owner of the $10,000 bond keeps the coupons and sells the stripped bond for $3,100, the purchaser is treated as having acquired an OID debt instrument for $3,100. The amount of the purchaser's OID equals $6,900. Between the purchase date and the maturity date of the bond, the purchaser must include in gross income the amount of the OID, as provided in § 1272(a).

Similarly, the purchaser of a stripped coupon is treated as having acquired an instrument with original issue discount. The OID allocable to each coupon is the excess, if any, of the amount payable on the due date of the coupon over the purchase price of the coupon. § 1286(a). Thus, if a coupon representing the right to receive $500 is purchased for $450, the $50 difference is original issue discount. Between the date of purchase and the coupon payment date, the purchaser includes in gross income the OID, as provided in § 1272(a).

Ajay Gupta
Financial Products Taxation
Reading #5

Short Sales

Code: § 1233.

Regulations: § 1.1233-1(a).

Provost v. United States, 269 U.S. 443 (1926).

Treatise: Keyes, Federal Taxation of Financial Instruments & Transactions, Chapter 16, Wash Sales and Short Sales, ¶ 16.03 (Extract).

(269 U. S. 443)

PROVOST et al. v. UNITED STATES.

(Argued Nov. 18, 1925. Decided Jan. 4, 1926.)

No. 258.

1. Internal revenue ⟸19(1)—"Loan" and "return" transactions incidental to short sales of corporate stock held taxable transfers, within Revenue Acts of 1917 and 1918.

Transfers of shares of corporate stock involved in "loan" and "return" transactions incidental to "short sales," evidenced by loan tickets and borrowed stock return tickets, *held* taxable transfers, within War Revenue Act 1917, tit. 8, schedule A, par. 4 (Comp. St. 1918, § 6318h), and Revenue Act 1918, tit. 11, schedule A, par. 4 (Comp. St. Ann. Supp. 1919, § 6318p).

2. Brokers ⟸24(1)—Relation between customer and broker, receiving deposits of stock as security for advances, is that of pledgor and pledgee, with authority to repledge.

The relation of customer and broker, with whom customer deposits stock as security for advances, or who purchased securities for account of customer, is technically that of pledgor and pledgee, with authority on part of broker to repledge to extent of his advances, subject always to requirement that he have available, either in actual possession or lodged with bank on repledge, for delivery to customer on payment of balance due, specific securities of kind and amount purchased.

3. Internal revenue ⟸19(1)—Re-enactment of provision after administrative interpretation held indicative of purpose to continue act as so construed, in view of subsequent express charge.

Enactment by Congress of Revenue Act 1918, tit. 11, schedule A, par. 4 (Comp. St. Ann. Supp. 1919, § 6318p), after ruling of Attorney General that similar provision in War Revenue Act of 1917 did not exempt loan and return of shares of stock incidental to short sales from transfer tax, and the subsequent enactment of Revenue Act November 23, 1921, tit. 11, schedule A, par. 3 (Comp. St. Ann. Supp. 1923, § 6318p), expressly exempting such transfers, must be considered as an indication of legislative purpose to tax such transfers by act of 1918 until enactment of 1921 act.

4. Words and Phrases—"Short sale" defined.

A "short sale" is a contract for sale of shares of stock which seller does not own, or certificates for which are not within his control, so as to be available for delivery at the time when, under rules of the exchange, delivery must be made.

[Ed. Note.—For other definitions, see Words and Phrases, First and Second Series, Short.]

Appeal from the Court of Claims.

Suit by George D. Provost and another, copartners trading as Provost Bros. & Co., against the United States. Judgment for the United States, and plaintiffs appeal. Affirmed.

For opinion below, see 60 Ct. Cl. 49.

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*Messrs. Charles E. Hughes, Samuel P. Goldman, and William F. Unger, all of New York City, for appellants.

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*Mr. Alfred A. Wheat, of New York City, for the United States.

Mr. Justice STONE delivered the opinion of the Court.

The appellants are copartners engaged in business as stockbrokers with membership in the New York Stock Exchange. They brought suit in the Court of Claims to recover, as an illegally exacted tax, the cost of internal revenue stamps affixed by them in the period from 1917 to 1920 to "tickets" which were documentary evidence of transactions commonly known in the stockbrokerage business as the "loan" of shares of stock and the return by the borrower to the lender of shares of stock "borrowed." The case was tried upon agreed facts embodied in the findings of the court below, and from the judgment for the defendant in that court the case was brought here on appeal. Judiciai Code, § 242 (Comp. St. § 1219), before amendment of 1925 (43 Stat. 941).

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[1] *The applicable provisions of the statutes are to be found in War Revenue Act of 1917, title 8, schedule A, par. 4, 40 Stat. 300, 322 (Comp. St. 1918, § 6318h), which is printed in the margin,[1] and in the similar provision

[1] Act Oct. 3, 1917, c. 63, tit. 8, schedule A, par. 4, 40 Stat. 300, 322:

"(4) Capital stock, sales or transfers: On all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock in any association, company, or corporation, whether made upon or shown by the books of the association, company, or corporation, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock or not, on each $100 of face value or fraction thereof, 2 cents, and where such shares of stock are without par value, the tax shall be 2 cents on the transfer or sale or agreement to sell on each share, unless the actual value thereof is in excess of $100 per share, in which case the tax shall be 2 cents on each $100 of actual value or fraction thereof: Provided, that it is not intended by this title to impose a tax upon an agreement evidencing a deposit of stock certificates as collateral security for money loaned thereon, which stock certificates are not actually sold, nor upon such stock certificates so deposited: Provided, further, that the tax shall not be imposed upon deliveries or transfers to a broker for sale, nor upon deliveries or transfers by a broker to a customer for whom and upon whose order he has purchased same, but such deliveries or transfers shall be accompanied by a certificate setting forth the facts: Provided further, that in case of sale where the evidence of transfer is shown only by the books of the company the stamp shall be placed upon such books; and where the change of ownership is by transfer of the certificate the stamp shall be placed upon the certificate; and in cases of an agreement to sell or where the transfer is by delivery of the certificate assigned in blank there shall be made and delivered by the seller to the buyer a bill or memorandum of such sale, to which the stamp shall be affixed; and every bill or memorandum of sale or agreement to sell before mentioned shall show the date thereof, the name of

of the Revenue Act of 1918, title 11, schedule A, par. 4, 40 Stat. 1057, 1135 (Comp. St. Ann. Supp. 1919, § 6318p), which may, for the purposes of this case, be taken to be a re-enactment of the 1917 provision. Both acts imposed a stamp tax of 2 cents per share upon "all sales or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock." The question presented is whether the transfers of shares of corporate stock involved in the "loan" and "return" transactions in accordance with the rules and practice of the Stock Exchange, are taxable transfers within the meaning of the statute.

[4] The loan of stock is usually, though not necessarily, incidental to a "short sale." As the phrase indicates, a short sale is a con-
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tract for the sale of shares which the *seller does not own or the certificates for which are not within his control so as to be available for delivery at the time when, under the rules of the Exchange, delivery must be made. Under the rules of the New York Stock Exchange, applicable so far as the facts of this case are concerned, a broker who sells stock is required to make delivery of the certificates on the next business day. If he does not have them available, he must procure them for the purpose of making delivery. This he may do by purchasing or borrowing the required shares, delivery of the certificates to be made to the broker to whom he has already contracted to sell.

If he borrows them, he deposits with the lending broker their full market price; and until the loan is returned, this deposit is maintained, by means of daily payments back and forth between the borrower and the lender, at the varying level of the market value
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of the shares loaned. *The lender, who thus receives in money the full market value of the shares—much more than he would ordinarily realize by pledging them—usually pays interest on the money so received, at the current rate for demand loans. But the rate of interest is a matter of negotiation and agreement, and the deposit may, on occasion, carry no interest, or the borrower of the stock may pay a premium when the stock is greatly in demand.

During the continuance of the loan the borrowing broker is bound by the loan contract to give the lender all the benefits and the lender is bound to assume all the burdens incident to ownership of the stock which is the subject of the transaction, as though the lender had retained the stock. The borrower must accordingly credit the lender with the amount of any dividends paid upon the stock while the loan continues and the lender must assume or pay to the borrower the amount of any assessments upon the stock. The lender of the stock, concurrently with the receipt of the deposit, delivers to the borrower the certificates of the stock lent, and the transaction is evidenced by a "loan ticket," to which the broker lending the stock affixes the revenue stamps here in question. The stock thus borrowed then becomes available for delivery on the short sale.

The original short sale is thus completed and there remains only the obligation of the borrowing broker, terminable on demand, either by the borrower or the lender, to return the stock borrowed on repayment to him of his cash deposit, and the obligation of the lender to repay the deposit, with interest as agreed. The stock for this purpose, if not provided by the customer, must be obtained by borrowing stock of like kind and amount from other brokers, or by purchasing the stock in the open market and charging the customer, for whose account the sale was originally made, with the purchase price. In that case the short sale transaction and the
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borrowing *transaction as well are brought to their conclusion by the actual purchase of stock of which the customer was short at the time when the sale was made and the delivery of the stock, thus purchased, to the lender.[2] The return transaction in every case is evidenced by a "borrowed stock return ticket" to which the borrowing broker affixes the revenue stamps. The claim of the appellants comprises the cost of stamps purchased by them and affixed to loan tickets or to borrowed stock return tickets pursuant to Treasury regulations.

It will be observed that the completed short sale transaction usually involves four separate steps in each of which there is either a sale or a complete transfer of all the legal elements of ownership. These are (1) the sale of the stock by the person effecting the short sale, followed by the transfer and delivery of the certificates for the borrowed stock to the purchaser's broker; (2) the transfer of the shares from the lender to the borrower, who uses them for delivery on the customer's short sale; (3) the purchase by the borrowing broker of the stock required to repay the loan; and (4) the transfer and delivery by the borrower to the lender of the

the seller, the amount of the sale, and the matter or thing to which it refers. Any person or persons liable to pay the tax as herein provided, or anyone who acts in the matter as agent or broker for such person or persons who shall make any such sale, or who shall in pursuance of any such sale deliver any stock or evidence of the sale of any stock or bill or memorandum thereof, as herein required, without having the proper stamps affixed thereto with intent to evade the foregoing provisions shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding $1,000, or be imprisoned not more than six months, or both, at the discretion of the court."

[2] In practice on the New York Stock Exchange, deliveries on sales and on stock loaned and returned, evidenced by loan tickets and borrowed stock returned tickets, are usually cleared on balance through the Stock Exchange Clearing House, so that the certificates pass directly from the lender to the purchaser on the short sale when stock is borrowed, and from the seller to the lender when borrowed stock is returned.

certificates for the purchased shares to replace the shares borrowed. Each transfer may be accompanied by a physical delivery of certificates of the stock transferred; but the intermediate deliveries in (2) and (3) are usually eliminated by use of the Stock Exchange Clearing House.

It is conceded that the first and third transactions are taxable as "sales" or "agree-
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ments to sell" within the *meaning of the statute; but it is contended that the second and fourth are not subject to the tax, because they involve neither a transfer of the legal title to the stock loaned and returned, nor "deliveries" of the shares or certificates representing them within the meaning of the acts of 1917 and 1918, and that taking into account the history and purposes of the two statutes, it was not intended to include these transactions among the taxable transfers described.

On the argument it was also earnestly urged that the lender of stock is in a position analogous to that of a pledgor of the stock which he lends; that in consequence there is no transfer of title to the stock within the meaning of the taxing provisions of the two acts, and that in any event the lender is in the position of a borrower of money and the transaction falls within the proviso of the acts exempting from the tax deposits of stock certificates as collateral security for money loaned.

[2] These arguments ignore the essential legal characteristics of the loan transaction. It may be agreed for the purpose of this discussion, as was argued at the bar, that it is the law of many jurisdictions, including New York, where these transactions occurred, that the relation of the customer and the broker with whom the customer deposits stock as security for advances, or who purchases securities for account of the customer, is technically that of pledgor and pledgee, with authority and power on the part of the broker to repledge to the extent of his advances. See Richardson v. Shaw, 209 U. S. 365, 374, 28 S. Ct. 512, 52 L. Ed. 835, 14 Ann. Cas. 981; Gorman v. Littlefield, 229 U. S. 19, 33 S. Ct. 690, 57 L. Ed. 1047; Duel v. Hollins, 241 U. S. 523, 36 S. Ct. 615, 60 L. Ed. 1143; Skiff v. Stoddard, 63 Conn. 198, 26 A. 874, 28 A. 104, 21 L. R. A. 102; Markham v. Jaudon, 41 N. Y. 235; Lawrence v. Maxwell, 53 N. Y. 19; Taussig v. Hart, 58 N. Y. 425; Caswell v. Putnam, 120 N. Y. 153, 24 N. E. 287. But that view of their legal relationship finds support in the agreement between the customer and the broker which contemplates, as
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the law requires, that the *broker should at all times have on hand specific securities for delivery to the customer on payment of the amount of the broker's advances for the customer's account. Although the broker has an implied authority to substitute other securities of the same kind and amount for the securities which he holds for his customer, and to repledge them to the extent of his advances, courts have not dispensed with the requirement that he should at least have, either in his own possession or lodged with his bank on the repledge, specific securities of the kind and amount purchased for his customer, available for delivery to the customer on payment of the balance due. Richardson v. Shaw, supra; Skiff v. Stoddard, supra; Taussig v. Hart, supra; Lawrence v. Maxwell, supra; Caswell v. Putnam, supra. See Carlisle v. Norris, 215 N. Y. 400, 109 N. E. 564, Ann. Cas. 1917A, 429. For breach of this duty he is liable, under the law of New York, for conversion (Markham v. Jaudon, supra; Lawrence v. Maxwell, supra; Taussig v. Hart, supra; Mayer v. Monzo, 221 N. Y. 442, 117 N. E. 948), and guilty of a criminal offense (Penal Law N. Y. [Consol. Laws N. Y. c. 40] § 956).

But the borrower of stock holds nothing for account of the lender. The procedure adopted and the obligations incurred in effecting a loan of stock and its delivery upon a short sale neither contemplate nor admit of the retention by either the borrower or the lender of any of the incidents of ownership in the stock loaned. The seller, having contracted to sell securities which he does not own, is under the necessity of acquiring dominion over stock of the kind and amount which he has sold, with unrestricted power of disposition of it in order that he may fulfill his contract. Whether his broker acquires the stock by purchase or by giving to the lender of it the market value of the stock plus his personal obligation to acquire and return to the lender, on demand, a like kind and amount of stock, the legal effect of the transfer is the same. Upon the physical de-
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livery of the certificates of *stock by the lender, with the full recognition of the right and authority of the borrower to appropriate them to his short sale contract, and their receipt by the purchaser, all the incidents of ownership in the stock pass to him.

When the transaction is thus completed, neither the lender nor the borrower retains any interest in the stock which is the subject-matter of the transaction and which has passed to and become the property of the purchaser. Neither the borrower nor the lender has the status of a stockholder of the corporation whose stock was dealt in, nor any legal relationship to it. Unlike the pledgee of stock who must have specific stock available for the pledgor on payment of his loan, the borrower of stock has no interest in the stock nor the right to demand it from any other. For that reason he can be neither a pledgee, trustee nor bailee for the lender, and he is not one "with whom stock has been deposited as collateral security for money loaned." For the incidents of ownership, the lender has substituted the personal obliga-

tion, wholly contractual, of the borrower to restore him, on demand, to the economic position in which he would have been, as owner of the stock, had the loan transaction not been entered into.

When the borrower returns the borrowed stock, he acquires it by purchase or by borrowing again and in the process acquires and transfers to the lender all the incidents of legal ownership in securities which neither possessed before.

We therefore conclude that both the loan of stock and the return of borrowed stock involve "transfers of legal title to shares of stock" within the express terms of the statute; and while we are not called upon to define or enumerate the precise conditions which must attend the delivery of a certificate of stock, under other circumstances, to bring it within the taxing provisions of the act, we think it clear that deliveries of in-
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dorsed cer*tificates of stock incidental to these transfers of legal title are "deliveries of * * * shares or certificates of stock" within the language of the statute.

It follows that the borrowing of stock and the return of borrowed stock are both subject to the tax unless there is to be found in the legislation now under consideration or in its history a purpose sufficiently definite and controlling to exclude the transactions in question from the operation of its applicable language.

In earlier revenue legislation, the act of 1898 (30 Stat. 448, 458) and the act of 1914 (38 Stat. 745, 759), a stamp tax was imposed on "all sales or agreements to sell or memoranda of sales or deliveries or transfers of shares or certificates of stock." No attempt appears to have been made under these statutes to impose a tax on loans of stock or returns of borrowed stock. In March, 1915, the Commissioner of Internal Revenue, in response to an inquiry which incorrectly stated that the transfer involved in borrowing and returning borrowed stock "does not represent a change of ownership" made a decision (T. D. 2182) that such transactions were not subject to the tax under the act of 1914. Neither of these acts contains the words "or transfers of legal title to shares or certificates" which, as we have indicated, are of significance in the acts of 1917 and 1918 because precisely applicable to the transfers under consideration.

The act of 1917 became a law on October 3, 1917. On March 23, 1918, the Attorney General rendered an opinion (31 Op. Attys. Gen. 255) that the transfers of stock involved in loans of stock and returns of borrowed stock were subject to the tax under the act. This opinion was adopted by the Treasury Department in its ruling of March 30, 1918. T. D. 2685. When the bill which became the Revenue Act of 1918 was pending, the attention of the Senate committee on finance was directed to the opinion of the Attorney General
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and the ruling of the Treasury Depart*ment, and it was urged in public hearing (September 11, 1918) to amend the bill so as to include "mere loans of stock or the returns thereof" within the proviso exempting from the tax deposits of certificates of stock as collateral security. The recommended change was not adopted. The provision of the act of 1917 was re-enacted without substantial change and continued on the statute books until the adoption of the Revenue Act of November 23, 1921 (chapter 136, 42 Stat. 227), when the proposed change was incorporated in it (title 11, schedule A, par. 3, 42 Stat. 304 [Comp. St. Ann. Supp. 1923, § 6318p]).

[3] We can find in this history no substantial basis for the contention that there was a legislative adoption of any settled administrative construction of the statute adverse to the position now taken by the government. On the contrary, the enactment of the Revenue Act of 1918 without material change of the provision in question must, we think, be taken as indicating a purpose to continue in force the existing law as interpreted by the Attorney General (United States v. G. Falk & Bro., 204 U. S. 143, 27 S. Ct. 191, 51 L. Ed. 411); and when Congress adopted in the amended law of 1921 the very suggestion made and rejected two years before, it ther intended to effect a change in the law as it had previously existed (Smietanka v. First Trust & Savings Bank, 257 U. S. 602, 42 S. Ct. 223, 66 L. Ed. 391).

Nor are we able to find in the statute any expression of a general purpose to exclude from the application of its express language the type of transactions now under consideration. It evidenced a purpose not only to tax all sales or agreements to sell which had been previously taxed, but to extend the taxing provision to all transfers of legal title to shares or certificates whether technical sales or not. It was not suggested at the argument that other forms of transfer, not sales and not expressly excepted from the operation of the act by this proviso, such as gifts or trans-
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fers in trust for the benefit of the trans*feror, were not subject to the tax; and the Department has consistently ruled that they were. See T. D. Regulations 40.

As already indicated, the borrowing of stock and the returning of borrowed stock do not fall within the description of those classes of transactions expressly exempted from the tax. Nor do they so resemble them in a popular and nontechnical sense as to warrant their inclusion among the exceptions. Even in a loose and colloquial sense it cannot be said that the loan of stock is a "deposit of stock certificates as collateral security for money loaned thereon." We therefore conclude that while there is no indication of a purpose to impose a discriminatory tax upon short sales or transactions necessarily in-

volved in short sales, there was a general purpose to tax all transfers of legal ownership of shares of stock which includes those made necessary in order to complete a short sale. It follows that they are subject to the tax imposed upon the class of transactions in which they are included.

Judgment affirmed.

(269 U. S. 360)

UNITED STATES v. DAUGHERTY.

(Argued Dec. 1, 1925. Decided Jan. 4, 1926.)

No. 303.

1. Criminal law ⟸991(½)—Sentences should reveal with fair certainty intent of court, and exclude serious misapprehensions.

Sentences in criminal cases should reveal with fair certainty the intent of the court, and exclude serious misapprehensions by those who must execute them.

2. Criminal law ⟸995(6)—Judgment held to impose three 5-year terms, to be served consecutively, and not concurrently.

In prosecution for violation of the Harrison Anti-Narcotic Act (Comp. St. §§ 6287g–6287q), where indictment contained three counts, a judgment adjudging that defendant "be confined for the term of five years on each of said three counts, * * * said term of imprisonment to run consecutively, and not concurrently," *held* to impose a total imprisonment of 15 years, made up of three 5-year terms.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

James Daugherty was convicted of violating the Harrison Anti-Narcotic Act. The conviction was interpreted and affirmed by the Circuit Court of Appeals (2 F.[2d] 691), and rehearing denied (4 F.[2d] 344), and defendant brings certiorari. Judgment of the Circuit Court of Appeals reversed, judgment of District Court affirmed, and cause remanded for further proceedings.

Mr. Assistant Attorney General Donovan, for the United States.

Mr. Anthony P. Nugent, of Kansas City, Mo., for respondent.

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*Mr. Justice McREYNOLDS delivered the opinion of the Court.

An indictment of three counts charged respondent with violating Harrison Anti-Narcotic Act, c. 1, 38 Stat. 785 (Comp. St. §§ 6287g–6287q), by making unauthorized sales of cocaine to three different persons on different days. Each count alleged a completed sale to the named individual on a specified day. The judgment below followed a plea of guilty:

It is by the court considered and adjudged that said defendant is guilty of the crime aforesaid, and that as punishment therefor said defendant be confined in the United States penitentiary situated at Leavenworth, Kansas, for the term of five (5) years on each of said three counts, and until he shall have been discharged from said penitentiary by due course of law. Said term of imprisonment to run consecutively and not concurrently.

He took the cause to the Circuit Court of Appeals for the Eighth Circuit and there maintained:

(1) That the [trial] court erred in imposing a sentence of 15 years upon defendant, James Daugherty; that the court exceeded its jurisdiction in imposing a sentence of 15 years, which is 10 years above the maximum penalty prescribed for a violation of the Harrison Anti-Narcotic Act, as amended by Revenue Act of 1918, 40 Stat. 1130 (Comp. St. Ann. Supp. 1919, §§ 6287g, 6287*l*).

(2) That each of the offenses charged, alleged, and set forth in the indictment constitute a single continuous act inspired by the same intent, which is equally essential to each of the offenses charged in the three counts of said indictment, and the court erred and exceeded its jurisdiction in imposing a sentence of 15 years upon defendant.

That court interpreted and affirmed the judgment.

It held that:

"The contention that each sale should be taken as resulting from one and the same criminal intent and therefore the three counts

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charge only one crime, is *not sound; because criminal intent is not an element of the crime, and because each count charges a different sale to a different person and on a different day, and if the sales were made as charged they constituted three separate offenses." Daugherty v. United States, 2 F.(2d) 691.

It further concluded that the sentence was for 5 years only and, in support of this view, said:

"Where sentences are imposed on verdicts of guilty, or pleas of guilty, on several counts or on several indictments consolidated for trial, it is the rule that the sentences so imposed run concurrently, in the absence of specific and definite provision therein that they be made to run consecutively by specifying the order of sequence. If the order in which the terms of imprisonment for the different offenses is to be served, is not clearly designated, the terms are to be served concurrently, and the defendant cannot be held in further confinement under the sentence after the expiration of the longest term imposed. Cumulative sentences are permissible, and in some cases are appropriate, but when imposed on different counts or indictments there must be certainty in the order of sequence."

⟸For other cases see same topic and KEY-NUMBER in all Key-Numbered Digests and Indexes

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Fed. Tax. Fin. Instruments & Transactions ¶ 16.03

*1 Federal Taxation of Financial Instruments & Transactions
October 2020
Keyes

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Part IV. Financial Transactions

16.03 TREATMENT OF SHORT SALE TRANSACTIONS

A short sale generally occurs where a taxpayer borrows property and then sells the borrowed property to a third party. In general, the tax consequences of the short sale remain open until the taxpayer delivers identical property to the lender to close the sale. However, special anti-abuse rules contained in Sections 1233(b) and 1233(d) may apply to prevent the conversion of short-term gain into favorable long-term capital gain and, conversely, long-term loss into short-term capital loss.

16.03[1] Description of a Short Sale

For tax purposes, there are two types of short sale transactions to be considered: (1) a short sale and (2) a short sale against the box. In a short sale, the seller sells stock or other securities that he currently does not own. The short seller borrows the stock or securities (usually from or through a broker) in order to make the required delivery to the buyer. The sales proceeds are deposited with the lender and the short seller maintains that deposit until identical property is returned to the lender. The lender may credit the short seller's account with a rebate fee equal to a portion of the income earned on the investment of the collateral. However, the short seller remains under an obligation to deliver identical property to the lender and is bound to give the lender all of the benefits the lender would have received had the stock or securities been retained. Thus, if dividends are declared, the short seller must pay to the lender an equivalent amount. The short seller later “closes” the short sale by purchasing identical property and delivering it to the lender. [77]

Short sales are often used as a tool for speculation. That is, if the seller believes that a particular stock will subsequently decline in value, he or she can sell borrowed shares when the stock value is high. If all goes as planned, the short sale is closed with stock purchased after the price has fallen. [78]

Example 16-9

Individual *A* wishes to profit from an expected decline in the value of publicly traded corporation *X* stock. Assume that on February 1, 1995, the value of the *X* stock is $5 per share. *A* decides to sell *X* stock “short” through her broker. Accordingly, the broker borrows 100 shares of *X* stock on *A* 's behalf and sells the shares. The broker retains the $500 sale proceeds and any income earned on the proceeds as collateral for *A* 's obligation to return one hundred shares of *X* stock.

On August 2, 1995, the value of the stock has declined to $4 per share, and *A* instructs her broker to close the short sale. The broker buys 100 shares of *X* stock for $400 on behalf of *A* and delivers the stock to the lender. *A* has realized a gain of $100, the difference between the $500 proceeds of the sale of the borrowed stock and the $400 purchase price of the replacement stock.

***2** A "short sale against the box" occurs if the short seller actually owns property that is identical to the borrowed property used in making the short sale, but the seller does not intend to use this property in making the immediate sale. The sale is subsequently closed out by either purchasing identical property and delivering it to the lender, or simply delivering to the lender the identical property that was held at the time of the short sale (i.e., "held in the box"). Thus, in Example 16-9, a short sale against the box would have arisen if *A* had held the same securities at the time of the short sale but did not intend to deliver them to the buyer in the February 1, 1995, sale.

Whether a transaction is properly characterized as a short sale depends upon the facts and circumstances of each case.[79] As indicated above, the key factor is the intention of the seller. If the seller has no intention of making a short sale and his or her broker is aware of this, a transaction that appears to be a short sale may not be treated as one. For example, a short sale does not arise if a taxpayer directs his broker to sell shares that the broker knows that the taxpayer owns and intends to sell, but cannot access immediately.[80] Similarly, where the intent to sell is established, the mere failure to deliver certificates to a broker (who is therefore forced to borrow securities to effect the sale) is not alone sufficient to establish a short sale.[81]

Conversely, a short sale may be found where it is unclear whether the taxpayer intended to use certain stock in his or her possession to complete a sale.[82] In such a case, the determining factor will be what was actually done, not what the taxpayer may have intended to do.[83] For example, a short sale may be found where a broker treats a transaction as a short sale, and the taxpayer does not object to this treatment when informed by the broker.[84] This assumes the short sale is not subject to the constructive sale provisions of Section 1259.[84.1]

However, under the Taxpayer Relief Act of 1997 (TRA '97)[84.2] if a taxpayer enters into a short sale of property and such property becomes substantially worthless, the taxpayer must recognize gain as if the short sale were closed when the property became substantially worthless.[84.3] Congress extended the statute of limitations with respect to such gain recognition to the earlier of (1) three years after the Treasury is notified that the position has become substantially worthless, or (2) six years after the date of filing of the income tax return for the taxable year during which the position became substantially worthless.[84.4] The provision applies to property that becomes substantially worthless after August 5, 1997.[84.5]

16.03[2] General Tax Aspects

***3** For income tax purposes, a short sale remains open until the short seller closes the short sale by replacing the property that was borrowed from the lender.[85] Thus, gain or loss from the short sale is determined for tax purposes when the sale is closed,[86] not when the short seller borrows the property and makes the short sale.[87] In effect, the timing of gain or loss recognition remains open until the seller closes the sale by replacing the borrowed property.

The character of the gain or loss depends on whether the property used to close the short sale is a capital asset in the taxpayer's hands.[88] If the taxpayer uses a capital asset to close the short sale, any gain or loss is capital in nature.[89] If the taxpayer uses an ordinary asset to close the short sale, any gain or loss is ordinary.[90] Generally, whether a capital gain or loss is long-term or

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short-term is determined by the length of time that the taxpayer held the property that was used to close the short sale. [91] Section 1233, however, does not apply in the case of certain hedging transactions. [92]

Importantly, because gain or loss is not taken into account until closing, a taxpayer can use a short sale against the box as a technique to lock in a gain in one taxable year, but defer its recognition until a following year. [93]

Example 16-10

Assume that at the end of year 1, Individual *A* owns 100 shares of *X* corporation stock having a tax basis of $5 per share and FMV of $20 per share. *A* would like to assure herself of receiving $20, but does not wish to recognize gain in the current year. Accordingly, *A* enters into a short sale by instructing her broker to sell 100 shares short. *A* waits until the following year and closes the short sale by delivering to the lender the 100 shares of *X* stock that she held at the time of the short sale. When the transaction is complete, *A* receives the $2,000 sale proceeds. Thus, *A* has fixed the $1,500 gain in year I and deferred its recognition until year 2.

While a short sale against the box can be a valuable tax planning tool to lock in and defer recognition of gain, taxpayers cannot generally use a short sale to change the character of the gain or loss as short-term or long-term capital gain or loss. The special anti-abuse rules contained in Sections 1233(b) and 1233(d), which are discussed below, are intended to prevent such possibilities. [94]

16.03[3] Special Anti-Abuse Provisions

Prior to the enactment of the special anti-abuse rules, taxpayers were able to use short sales as a technique to circumvent the holding period rules of the Code. Through a short sale, short-term capital gain could be converted into long-term capital gain, while long-term capital loss could be converted into short-term capital loss. Sections 1233(b) and 1233(d) are designed to prevent taxpayers from using short sales for these purposes. [95]

***4** Much of the importance of the long-term or short-term nature of capital gain or loss has been lost as a result of the changes made in the Tax Reform Act of 1986 (TRA '86). [96] In particular, TRA '86 eliminated the favorable capital gains deduction and the detriment associated with long-term capital losses. However, rate differentials for individuals have appeared again as Congress has increased the individual tax rates on ordinary income while leaving the capital gains rate intact. [97] Accordingly, to this extent, the capital gain holding period rules have renewed significance.

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Ajay Gupta
Financial Products Taxation
Reading #6

Wash Sales

Code: §§ 1091(a), (d); 1223(3). Skim § 1041.

Regulations: §§ 1.1091-1(g), -2(a).

Code: § 267(a)(1), (b), (c), (d), (g).

Regulations: § 1.267(d)-1(a), (c)(3).

Treatise: Bittker & Lokken, Federal Taxation of Income, Estates & Gifts, Chapter 44, Wash Sales of Securities, ¶ 44.8 (Extract) (Attached).

Problems:

1. On December 1, 2022, Mrs. Washmore sold 1,000 shares of X Corporation stock for $50,000. She had purchased the stock exactly two years earlier for $60,000. On December 15, 2022, she purchased another 1,000 shares of identical X Corporation stock for $55,000.

(a) What are the tax consequences of the December 1 sale?

(b) What is Mrs. Washmore's basis for the newly acquired shares?

(c) What is Mrs. Washmore's holding period for the newly acquired shares as of January 1, 2023?

(d) What results to Mrs. Washmore in (a)-(c) above (gain or loss, basis, and new holding period) if the December 1 sale had been for $75,000, and she had repurchased 1,000 shares of X Corporation stock on December 15 for $65,000?

(e) Is there any difference in the results to Mrs. Washmore in part (a) above if she had purchased the new shares on December 1 for $55,000, and sold the old shares on December 15 for $50,000?

(f) If the facts are the same as in (a) above, except that Mrs. Washmore sold her original shares on December 1 to her son, what results when the son sells those shares on March 15, 2023, for $55,000? Consider the consequences to both Mrs. Washmore and her son. *See* § 267(d)(2).

(g) Are the wash sale rules more or less stringent than those of § 267?

2. On June 1, 2022, Short borrowed 100 shares of B stock and sold them short for $9,000. Owning no B shares, Short purchased 100 shares of identical B stock on June 15, 2022, for $10,000 and "closed" the sale. On July 5, 2022, Short again purchased 100 shares of identical B stock at a price of $9,500.

(a) Does § 1091 apply to disallow Short's loss? *See* Reg. § 1.1091-1(g).

(b) What results if Short closed the sale on June 15, 2022, with identical B stock that Short had purchased on March 1, 2022?

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Part 5. Sales and Other Dispositions of Property

Chapter 44. Nonrecognition Transactions

44.8 WASH SALES OF SECURITIES

44.8.1 Introductory

To prevent the deduction of paper losses, § 1091, whose statutory predecessor was enacted in 1921, [1] provides that loss on a sale of securities may not be deducted if the taxpayer acquires, or enters into a contract or option to acquire, substantially identical securities within the period beginning 30 days before the sale and ending 30 days after the sale. Section 1091 states that "no deduction for the loss shall be allowed," rather than that the loss "shall not be recognized," but the restriction is tantamount to a nonrecognition provision. Under § 1091(d), the basis of the securities whose acquisition causes the loss on the wash sale to be disallowed equals the adjusted basis of the securities sold, adjusted for any difference between the selling and purchase prices. Another way of saying this is that the basis of the purchased securities is the sum of their cost and the loss barred by § 1091 on the sale. The disallowed loss thus may be recognized when the taxpayer's investment is finally closed out by a sale of the purchased securities. Section 1091, in other words, postpones recognition of losses rather than disallowing them permanently. This deferral function is buttressed by § 1223(4), which includes the period during which the taxpayer held the original securities in the holding period for the reacquired securities. [2]

The term "securities" is used here as an abbreviation for a longer statutory description: "shares of stock or securities [or] contracts or options to acquire or sell stock or securities." [3] Section 1091, for example, may deny loss realized on a sale of a share of stock, a bond, a futures contract on a debt instrument, or a stock option. Moreover, the loss-denial rule is triggered if, during the 61-day period beginning 30 days before the sale, the taxpayer either (1) purchases a substantially identical stock, security, contract, or option or (2) enters into a contract or option to purchase such property. [4] For example, § 1091 applies if a bond is sold and, within 30 days of the sale, a contract is made to purchase a substantially identical bond or if an option to purchase stock is acquired within 30 days before or after the day on which the taxpayer sells substantially identical stock. The provision does not apply, in contrast, to transactions in foreign currency or commodity futures. [5]

The operation of § 1091 is illustrated by Example 44-15, in which taxpayer *T*, who purchased 100 shares of *X* Company's Class A stock (lot *A*) in 1995 for $10,000, (1) sells the stock on December 1, 2001, for $7,500; (2) purchases 100 shares of the same company's Class B stock (lot *B*) on December 15, 2001, for $6,000; and (3) sells the Class B shares on January 15, 2002, for $6,500. If § 1091 is inapplicable because the Class B shares are not "substantially identical" to the Class A shares, *T* recognizes long-term capital loss on selling the Class A shares of $2,500 ($10,000 cost less $7,500 selling price) and short-term capital

gain on selling the Class B shares of $500 ($6,500 selling price less $6,000 cost). On the other hand, if the Class B shares are substantially identical to the Class A shares, the loss of $2,500 on selling lot *A* is disallowed by § 1091(a), but the Class B shares have a basis of $8,500 (cost of $6,000 plus the disallowed loss of $2,500), and their holding period includes the time when *T* held the Class A shares. Thus, on selling the Class B shares for $6,500, *T* has long-term capital loss of $2,000. This corresponds to *T* 's economic gain, since over the long haul she invested a total of $16,000 ($10,000 for lot *A* and $6,000 for lot *B*) and received a total of $14,000 ($7,500 for lot *A* and $6,500 for lot *B*). These results are summarized in Example 44-15.

Example 44-15

Tax Results

Date	Taxpayer's Action	Section 1091 Inapplicable	Section 1091 Applicable
1995	Buys lot *A* for $10,000	Basis—$10,000	Basis—$10,000
12/01/01	Sells lot *A* for $7,500	$2,500 LTCL (2001)	$2,500 loss disallowed
12/15/01	Buys lot *B* for $6,000	Basis—$6,000	Basis—$8,500
1/15/02	Sells lot *B* for $6,500	$500 STCG (2002)	$2,000 LTCL (2002)

***2** Because it permits taxpayers to recognize their economic losses on ultimately closing out their investments, § 1091 differs from § 267(a)(1), which ordinarily permanently disallows losses incurred by the seller on sales between related taxpayers. [6] If both § 1091 and § 267 apply, § 1091 controls, the taxpayer postpones recognition of the loss, and the transferee is not entitled to the benefits of § 267(d) (stepped-up basis in computing gain in certain situations) on a later resale. [7] Assume *A* sells *XYZ* stock (adjusted basis $100) to his sister *B* for $70 and purchases another block of identical stock for $70 within 30 days. *A* 's loss on the sale is disallowed by § 1091, but *A* 's basis for the second block is $100 (cost of $70 plus disallowed loss of $30). *A* will thus recognize the $30 loss if the second block is subsequently sold for its cost of $70. *B*, in contrast, takes a cost basis of $70 and thus will recognize gain if she sells the stock purchased from *A* at any price exceeding $70.

By its terms, § 1091(a) applies to all taxpayers except dealers in securities, who are exempted only with respect to transactions in the ordinary course of business. [8] The exemption of securities dealers presumably reflects a legislative judgment that they sell and replenish their merchandise as rapidly as possible without attempting to create tax losses. Moreover, they can effectively deduct unrealized losses by writing their inventory down to market value at the end of the taxable year in computing the cost of securities sold. [9]

Because losses are disallowed only if “substantially identical” securities are acquired within the specified time period, sophisticated investors wishing to deduct losses on depreciated securities can often replace them with securities of other issuers (or even with another class of the same issuer's securities) that are not substantially identical but are subject to similar market influences and hence serve substantially the same investment objectives. This aspect of § 1091, as well as the mechanical character of its 30-day limit, was recognized by Congress as early as 1923, in a report proposing a change in the rules that then taxed capital gains at a lower rate than ordinary income but allowed capital losses to be deducted against ordinary income:

The situation would be bad enough were we simply called upon to deal with losses actually incurred. But this is by no means the case. Many of these alleged losses are frequently nothing more than paper losses. Thus, in the case of investments, the taxpayer may sell securities at a price less than that paid for them, incur a loss which will be deducted from his income for tax purposes,

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and then after thirty days buy back those same securities. To be sure, they may, in the course of thirty days, have so risen in value as to make it unprofitable for him to buy them back, but, on the other hand, they may have fallen in value, in which event he will have made an actual profit on the transaction which, for income-tax purposes, appears as a loss. If he does not care to wait thirty days, he may incur his loss by the sale of his securities and at once buy with the proceeds of the sale securities of a similar class, of approximately the same value, and so find himself in substantially the same position as before the sale, having in the meanwhile realized a loss for tax purposes. [10]

***3** This gambit is not ordinarily feasible if the depreciated securities were issued by a closely held corporation, for want of a suitable investment alternative. If the only feasible way of preserving the taxpayer's economic position is to reacquire the same securities, the taxpayer will ordinarily have to enter into a formal or tacit repurchase arrangement before selling the first block, thus triggering disallowance of the loss under § 1091. For this reason, the restriction on wash sales is undoubtedly an effective prophylactic in the case of closely held securities, however easily it can be avoided in the case of marketable securities.

By laying down a mechanical rule, taking no account of the taxpayer's motive, § 1091 sometimes disallows losses realized by taxpayers who have no tax avoidance objective or who are forced into a transaction by circumstances beyond their control. For example, a taxpayer who pledges a block of securities for a loan and purchases another block in the belief that the issue will increase in value cannot deduct his loss if there is a precipitous drop in the market and the pledged securities are sold by the creditor within 30 days after the second block was purchased. [11] Section 1091 may also apply to flighty investors who wallow in despair when stock prices fall, sell their holdings at a loss, and then rush back to buy when there is a recovery. These cases illustrate a central dilemma of prophylactic rules: If they turn on the taxpayer's intent or motive, they create uncertainties and encourage taxpayers to be disingenuous about their plans; if they prescribe mechanical rules, they create certainty but are both over- and under-inclusive.

Occasionally, an investor can extract a benefit from § 1091. For example, if a taxpayer realizes loss on a sale but decides during the 30-day period that it would be better to save the loss for the following year, the taxpayer can repurchase the securities, deliberately bringing § 1091 into play, and sell the reacquired securities early during the next year. This change in plans will cost the investor a set of buy-sell commissions, but they might be offset by a larger tax benefit from the loss deduction.

Although the policy justification for the wash sale rule might apply to gains as well as losses, the rule has never encompassed gains. Taxpayers with current losses or loss carryovers therefore are seemingly free to sell appreciated securities, neutralize the gains with their losses, perpetuate their investment position by acquiring the same securities shortly before or after the sale, and thus effectively convert the losses into a stepped-up basis for the new securities. As suggested below, [12] however, the IRS may attack sale-reacquisition transactions serving no purpose other than tax reduction.

In application, § 1091 raises four principal interpretative problems, discussed below: (1) the types of transactions constituting wash sales; [13] (2) the scope of the term "substantially identical stock or securities"; [14] (3) matching losses with replacement securities in order to identify the losses to be disallowed and the replacement securities whose basis is to be adjusted; [15] and (4) the effect of transactions similar to wash sales that are outside the scope of § 1091. [16]

44.8.2 Transactions Constituting Wash Sales

***4** Loss on a sale or other disposition of securities (or a contract or option to buy or sell securities) is disallowed by § 1091(a) if, "within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date," the taxpayer acquires substantially identical securities (or a substantially identical contract or option) or enters into a contract or option to

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acquire such securities.[16.1] The "date of such sale or disposition" is the date the disposition is consummated, not the date when the taxpayer agrees to sell or is paid for the securities. This date is determined by the usual rule that property is disposed of when title passes or the benefits and burdens of ownership are transferred.[17] If the securities are sold through a broker on a stock exchange or the over-the-counter market, the date of sale is the "trade" or "contract" date, not the later "settlement" date when payment is due. Although a short sale is ordinarily not consummated for tax purposes until the securities are delivered by the short seller, the regulations provide that the day of the sale, not the day of the closing, controls under § 1091(a) if the taxpayer then owns (or holds a contract or option to acquire) the securities ultimately used to close the short sale.[18]

Similarly, the replacement securities are "acquired" on the date of the trade, not on the settlement date. Although the day of acquisition is disregarded in determining the holding period of capital assets, this is because § 1222 differentiates between periods that are "more than" and "not more than" a specified length.[19] Securities bought on January 1, 2001, for example, have not been held for "more than" one year if they are sold on January 1, 2002. Since the period prescribed by § 1091(a) begins 30 days before and ends 30 days after the sale, however, there is no reason to exclude the acquisition date. Thus, if securities are sold on January 1 and repurchased on January 31, § 1091 applies because the repurchase occurs on the thirtieth day following the date of the sale; the first safe day for repurchase is February 1. Section 1091(a) specifies a period of 30 days, not one month. For example, a sale on January 31 is a wash sale if replacement securities are acquired on March 1, even though the events are separated by more than a calendar month.

Section 1091(a) only applies to sales and other dispositions on which loss would otherwise be recognized. While barters and other taxable exchanges are covered, the provision does not apply to gifts, exchanges in nontaxable corporate reorganizations, and other transactions on which losses are not recognized. Moreover, since a loss must be realized before it can be disallowed, a taxpayer holding a block of appreciated securities and a block of identical depreciated securities can sell the appreciated securities and replace them within 30 days without running afoul of § 1091(a), even though sale of the depreciated securities would have resulted in a disallowed loss.[20]

***5** Replacement of securities disposed of brings § 1091(a) into play only if the replacement is "by purchase or by an exchange on which the entire amount of gain or loss was recognized by law." This language includes securities received by an employee as compensation, since they are "purchased" by rendering services to the employer,[21] but it exempts securities acquired by gift, bequest, stock dividend, partially or wholly tax-free corporate reorganization, or nontaxable event.[22]

A transaction is a wash sale only if, within the statutory 61-day period, the taxpayer either acquired substantially identical securities or "entered into a contract or option" to acquire such securities. If property is sold subject to a repurchase contract, the transaction is so transparent a wash sale that the IRS does not ordinarily need § 1091 to disallow the loss and can do so even if that provision does not apply because, for example, the property sold is real estate rather than securities.[23] However, § 1091(a) embraces not only obvious instances of tax avoidance but also purchase contracts resulting from arm's length bargaining with independent third persons.

More significant is the inclusion of options because a seller with an option to reacquire substantially identical securities (a call) has a significantly different economic position than a seller who reacquires, or is obligated to reacquire, such securities.[24] A call enables the seller to repurchase if the securities rise in value, but, unlike a repurchase or contract to repurchase, it does not subject him or her to the risk of a further decline in value because the option need not be exercised. Since the seller will benefit from an increase in the securities' value, however, it is reasonable to postpone recognition of the loss until the option expires or the securities obtained by exercising it are sold.[25]

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This justification raises questions about options that are contingent on events that may not occur, that specify a price substantially above the current market, or that contain other conditions that dilute their protective power. If the option is exercisable only in remote circumstances, the sale arguably closes out real loss rather than realizing a paper loss that can be recouped at will if the market improves. Yet, to import a judgment about the likelihood of exercise into the term "option...to acquire" would be inconsistent with the normal mechanical operation of § 1091. It is therefore not surprising that the IRS has ruled that an employee stock option triggered § 1091(a), even though it was subject to forfeiture if the employee ceased to be employed by the issuer. [26]

Section 1091(a) is not literally applicable if, within 30 days before or after a loss sale, a taxpayer sells a put on identical securities (an option giving the holder of the put the right to require the taxpayer to purchase the securities from the holder). The provision covers an "option...to acquire" substantially identical securities, but when a put is sold, the option lies with the other party, not the taxpayer. The distinction between calls and puts is somewhat arbitrary in this context because the relevant consideration under § 1091 should be the likelihood of the taxpayer reacquiring substantially identical securities within the 61-day period and the likelihood of an option being exercised depends on the market, not the personal whims of the person holding the option. The IRS has ruled, for example, that a put is treated as a contract to purchase, rather than as an option, if the price and other terms are such that the put is almost certain to be exercised. [27]

***6** The wash sale rule only applies if, within the relevant 61-day period, "the taxpayer" both realizes a loss and acquires substantially identical stock or securities. It does not apply if one taxpayer realizes loss and another person, even a related person, acquires such stock or securities. However, there may be cases where the identity of interest between a taxpayer and another person is so close that an acquisition by the other person is imputed to the taxpayer for this purpose. For example, in a 1933 decision, the Board of Tax Appeals held that the predecessor of § 1091(a) applied to a taxpayer's loss on selling bonds at fair market value to a corporation because the corporation, on the same day, exchanged the bonds at the same price to a trust, which the taxpayer had created and over which the taxpayer had retained "absolute dominion." [27.1] The taxpayer was sole shareholder of the corporation and was taxable on all of the trust's income under a predecessor of the grantor trust rules. According to the court, unless the wash sale rule applied

a trust like this one could be used deliberately to accomplish the very thing which Congress intended to frustrate....Although title to the bonds was acquired by the trust, actual command over the property was still in the [taxpayer]....The difference between acquisition by him personally and acquisition by the trust amounts only to a refinement of title and may be disregarded so far as [the rule] is concerned. [27.2]

Relying on this decision, the IRS, in 2008, concluded that § 1091(a) disallowed a loss that a taxpayer realized on selling stock in a market transaction because the taxpayer's individual retirement account (IRA) purchased the same number of shares in the same company, also in a market transaction, on the next day. [27.3]

In at least one area, literal application of the language of § 1091(a) so clearly results in overkill that the IRS has ruled in favor of a sensible alternative interpretation. Assume a taxpayer buys 100 shares of *XYZ* stock on January 1 and sells 50 of these shares on January 20 at a loss. Should the loss be disallowed because, within the previous 30 days, the taxpayer acquired identical securities, the 50 unsold shares? The IRS allowed the loss, explaining:

Congressional discussions and reports [relating to the statutory predecessor of § 1091] refer consistently to the "new acquisition" and to "repurchasing" and "buying back" stock or securities. These terms indicate an intent on the part of Congress to prevent a taxpayer's taking losses for tax purposes while giving up his position in a security for only a few days or not at all. However, they do not indicate an intent to disallow a loss sustained in a bona fide sale of securities made to reduce the taxpayer's holdings, even though the sale is made within thirty days after the securities were purchased. [28]

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This rationale probably also protects a taxpayer who sells 50 shares from a 150-share block covered by a single stock purchase order, even if the purchase order is executed in two installments and at two prices (e.g., because an order for 150 shares is treated as a round-lot order for 100 shares and an odd-lot order, at a higher price, for 50 shares). On the other hand, the ruling probably does not reach a sale of shares from a block accumulated over several days at various prices by a taxpayer who sought to attain a preestablished target but changed her mind and sold some of the block soon after reaching the target. Much could be said for aggregating all purchases during an uninterrupted period of stable or rising prices in applying the single-holding concept, so that none of the securities accumulated during this period would be treated as replacement securities in the event of a subsequent reduction in the taxpayer's portfolio; but neither the statutory language nor the legislative committee reports afford much support for this broad an exemption.

44.8.3 "Substantially Identical" Securities

***7** Section 1091(a) disallows losses not merely if, within the statutory 61-day period, the taxpayer either reacquires the same securities or replaces the securities sold with "substantially identical" securities. Recognizing that this phrase, which is not defined by the statute or the regulations, is satisfied by "something less than a perfect correspondence between the two securities," an early case observed:

The legislative history of the statute affords no clue to the nature of that "something less." But it is to be found, we think, in the statute's purpose.... The wash sales provision is designed to eliminate fictitious losses. As losses are a matter of economics, so the fiction lies in the lack of any change in economic position on the part of the taxpayer. The negative absence of change of position cannot, of course, exist where a new economic factor has come into being which can and has prompted positive economic action. In other words, the "something less" that is required consists of economic correspondence exclusive of differentiations so slight as to be unreflected in the acquisitive and proprietary habits of holders of stocks and securities. [29]

In slightly more concrete (but even more obtuse) terms, the IRS has announced the following criteria to determine whether bonds issued by the same obligor are "substantially identical" to each other:

Generally, respective bonds are "substantially identical"...if they are not substantially different in any material feature (unaffected by any related material feature, or as affected by such other feature or features), or because of differences in several material features considered together. On the other hand, they are not "substantially identical"...if they are substantially different in any material feature (unaffected by any related material feature, or as affected by such other feature or features), or because of differences in several material features considered together (i.e., even though each of such differences considered alone might not be regarded as substantial). In determining whether or not bonds purchased were substantially identical to bonds sold, the bonds purchased must, of course, be compared as they existed when purchased with the bonds sold as they existed when sold.

The fact that bonds of one series have the same, or approximately the same, market value on a particular day, or days, as bonds of another series of the same obligor, equally secured, and bearing interest at the same rate, does not necessarily establish that the respective bonds are "substantially identical," for that market situation can occur even if such respective series of bonds have substantially different maturity dates (unaffected, or as affected, by earlier call provisions) but, where they so differ, their market prices often are substantially higher on the substantially longer term series (than on the substantially shorter term series) when the market for the bonds is strong (usually during periods of generally low interest rates) and the reverse frequently occurs when the market for the bonds is weak (usually during periods of generally high interest rates). [30]

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***8** Several cases and rulings have wrestled with these criteria, as applied to call and maturity dates, interest rates, and types of security, but no precise standards have emerged.[31]

In comparing classes of stock, the features determining whether the shares are "substantially identical" are voting, liquidation, and dividend rights.[32] If the replacement securities are convertible back into the original securities, they should qualify as substantially identical to the original securities even though they have some different features, since they enable the taxpayer to restore the status quo ante by exercising the conversion privilege and thus to nullify the economic effect of the sale. Moreover, convertible securities can be viewed as options within the meaning of § 1091(a).[33]

Securities issued by different corporations are rarely substantially identical, even if the two companies are in the same industry and their securities are responsive to the same winds of economic change.[34] While this enables an astute investor to sell her depreciated securities at a loss without relinquishing a position in a particular industry or business area, a broader interpretation of "substantially identical," requiring the future internal policies of the two companies to be compared, would invite, if not require, expert testimony of investment counselors that would degenerate into a battle of words about hopelessly imponderable business prospects. Securities of different issuers may become fungible in special circumstances, however, as in the case of an impending corporate merger if the target company's securities fluctuate directly with the securities of the acquiring corporation for which they will be exchanged.[35] Also, securities issued by different but affiliated corporations may be substantially identical if the replacement securities can be converted into those that were sold. Similarly, stock of two mutual funds may be substantially identical if the two funds are index funds that track the same index.

The 1988 addition of the rule treating "contracts or options to acquire or sell stock or securities" as "stock or securities" for purposes of § 1091 raises a host of additional issues under the "substantially identical" requirement.[36] A contract or option to buy is clearly not substantially identical to a contract or option to sell. The cases and rulings holding that bonds with materially different maturity or call dates are not substantially identical are authority for finding that contracts or options are not substantially identical if their maturity or exercise dates are materially different. Similarly, a contract or option to buy or sell at one price is probably not substantially identical to an otherwise identical contract or option at a significantly different price. A contract or option to buy a particular security should be considered substantially identical to the security itself. For example, if a taxpayer realizes loss on selling an option to buy *XYZ* stock and, within the 61-day period, buys the stock itself, § 1091(a) should apply for the same reason that it has always applied to a taxpayer selling *XYZ* stock at a loss and purchasing an option to buy the same stock.

44.8.4 Allocating Replacement Securities to Particular Losses

***9** If a taxpayer owns a block of securities, sells them at a loss, and purchases the same number of substantially identical securities within the statutory 61-day period, the entire loss is disallowed and added to the basis of the replacement securities. However, if the taxpayer sells depreciated securities in several lots or purchases several lots of replacement securities, it is necessary to match the replacement securities with particular losses in order to identify both the losses to be disallowed and the replacement securities whose basis is to be adjusted under § 1091(d). The regulations require that the original and replacement securities be matched in chronological order, starting with the earliest loss and the earliest acquisition of replacement securities.[37]

Assume taxpayer *T* sells 100 shares of *X* stock (lot *A*) at a loss of $1,000, sells 100 additional shares (lot *B*) on the following day at a loss of $2,500, and purchases 100 shares (lot *C*) 10 days later. The purchase is matched with the first sale. As a result, the $1,000 loss on lot *A* is disallowed, a correlative increase of $1,000 is made in the basis of the replacement securities (lot *C*

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), and the holding period of lot *C* includes the holding period of lot *A* . [38] If *T* buys another 100 shares (lot *D*) within 30 days of the sale of lot *B*, the $2,500 loss on lot *B* is disallowed and added to the basis of lot *D*, whose holding period includes the holding period of lot *B* . The regulations illustrate the application of the chronological-sequence principle to other combinations of sales and purchases. [39]

44.8.5 Short Sales Followed by Other Sales or Short Sales

Section 1091(e), enacted in 1984, states that "rules similar" to those of § 1091(a) shall apply to loss on the closing of a short sale or a sale, exchange, or termination of a securities futures contract to sell if, within 30 days before or after the closing, sale, exchange, or termination, the taxpayer either sells substantially identical securities or enters into a second short sale of such securities. [40] Section 1091(e) differs from § 1091(a) in that the transaction triggering denial of loss is a second sale, not a reacquisition of substantially identical securities. Congress probably had two types of cases in mind in enacting § 1091(e).

First, assume taxpayer *T*, who holds appreciated stock, wants to lock in her gain but is not yet ready to sell the stock; she makes a short sale in order to achieve these dual objectives, but the stock goes up in value while the short sale is open, creating a loss in the short position. In the absence of § 1091(e), *T* might (1) buy other stock to close out the short position at a loss in December and (2) sell the original shares at a gain the following January, deducting the loss in one year and reporting the offsetting gain in the next. Section 1091(e) defeats this technique by disallowing the loss and requiring it to be added to the basis of the original shares.

***10** Second, assume *T* makes a short sale of stock she does not own. The stock's price goes up, producing a loss in the short position, but *T* remains confident that the price will soon fall. She closes out the short position at a loss, but simultaneously makes a second short sale of the same stock. In this case, the position taken in the original short sale is simply transferred to the second short position. Section 1091(e) reflects this continuity by denying the loss on closing the first sale and adding it to *T* 's basis for the second position, thus allowing it to offset gain or add to the loss on the closing of the second position.

44.8.6 Wash Sales Not Covered by § 1091

Section 1091 is not the IRS's only weapon against wash sales. Losses are sometimes disallowed under § 267(a)(1), which applies to losses on sales and exchanges between "related persons," whether or not the seller reacquires substantially identical property. [41] A loss may also be disregarded if the transaction in which it is realized lacks economic substance or is a sham. [42] When a wash sale runs afoul of these vague but ubiquitous principles, it is ineffective for tax purposes even if it falls outside the statutory boundaries of § 1091 because, for example, (1) gain, rather than loss, is realized; [43] (2) the transaction involves property other than stock, securities, or contracts or options to acquire or sell stock or securities; [44] (3) the seller is a dealer in securities; (4) the sale and repurchase are separated by more than 30 days; [45] or (5) the replacement securities are purchased by a related person. [46] The exclusion of these transactions from § 1091 suggests that they cannot be condemned merely because the sale and repurchase occur in close proximity, but only when additional factors (e.g., sale to an intermediary or pursuant to a repurchase agreement) evidence a lack of substance. Moreover, when a loss incurred on a sham transaction is disregarded, the taxpayer may be worse off than under either § 1091 or § 267(a)(1), both of which take account of the disallowed loss when the property is ultimately sold by the taxpayer or by the related person. [47]

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Footnotes

1 Revenue Act of 1921, Pub. L. No. 98, § 214(a)(5), 42 Stat. 227, 240. See HR Rep. No. 350, 67th Cong., 1st Sess. (1921), reprinted in 1939-1 CB (pt. 2) 168, 176, describing the provision as "preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges." The accompanying basis provision (Revenue Act of 1921, § 202(d)(2)) gave the replacement securities the same basis as the securities sold, which was correct only if the cost of the replacement securities was the same as the amount realized for the original securities, but this rule was replaced in 1924 by a provision similar to current § 1091(d). Revenue Act of 1924, Pub. L. No. 176, § 204(a)(11), 43 Stat. 253, 259; HR Rep. No. 179, 68th Cong., 1st Sess. (1924), reprinted in 1939-1 CB (pt. 2) 241, 254.

See generally Fuerch, The Wash Sale Rule: Deserving of a Second Look, 125 Tax Notes 1191 (Dec. 14, 2009); Krane, Losses From Wash Sales of Stock or Securities, 4 J. Corp. Tax'n 226 (1977). See also Axelrod, Keeping Recognized Stock Losses Out of the Wash, 176 Tax Notes Fed. 925 (Aug. 8, 2022); Fischer, Note, New Twists on an Old Plot: Investors Look to Avoid the Wash Sale Rule by Harvesting Tax Losses With Exchange-Traded Funds, 88 Wash. U. L. Rev. 229 (2010); Matthews, Tax Loss Harvesting: Can Robo-Advisers Navigate Wash Sale Rule? 153 Tax Notes 1345 (Dec. 12, 2016); Nijenhuis, Wash Sales Then and Now, 82 Taxes 181 (Mar. 2004) (six proposals for reforming § 1091 and related provisions); Schizer, Scrubbing the Wash Sale Rules, 82 Taxes 67 (Mar. 2004) ("The wash sale rules are too porous. Sophisticated taxpayers are deducting losses without changing their economic positions at all").

2 For § 1223, see infra ¶ 49.4; S. Rep. No. 665, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 CB (pt. 2) 496, 512. See also GCM 25867, published in 13 Tax Notes 571 (Sept. 7, 1981).

3 IRC § 1091(a). Contracts and options to buy or sell stock or securities are included only for sales after November 11, 1988. Pub. L. No. 100-647, § 5075, 102 Stat. 3342, 3682 (1988). The amendment including these contracts and options was sparked by the Tax Court's holding in Gantner v. CIR, 91 TC 713 (1988), aff'd, 905 F2d 241 (8th Cir. 1990), that stock options are not "securities" for purposes of § 1091. See HR Rep. No. 1104, 100th Cong., 2d Sess. 131–132 (1988) (Conf. Rep.).

The IRS has proposed a revenue procedure under which § 1091(a) would not apply to loss on a redemption of shares in a money market fund if the loss does not exceed one half of one percent of the taxpayer's adjusted basis for the shares. The IRS proposed the procedure in response to proposed rules of the Securities Exchange Commission (SEC) that would increase the likelihood of losses occurring on these redemptions, and it will adopt the procedure only if the SEC finalizes these rules. Notice 2013-48, 2013-31 IRB 120.

4 For whether securities are "substantially identical," see infra ¶ 44.8.3.

5 Rev. Rul. 74-218, 1974-1 CB 202 (foreign currency; definition of "security" in § 1236 cited as relevant); Rev. Rul. 71-568, 1971-2 CB 312 (commodity futures). See Horne v. CIR, 5 TC 250 (1945) (certificate of membership on commodity exchange not subject to § 1091, but loss disallowed because sale after purchase of replacement membership as part of tax reduction plan left taxpayer in same position as before plan was put into effect).

6 For § 267, see infra ¶ 78.1.

7 IRC § 267(d) (last sentence); Rev. Rul. 72-151, 1972-1 CB 225 (if both § 267 and § 1031 apply, the basis of property acquired by the taxpayer is governed by § 1031(d)).

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8 In its present form, the exclusion of dealer transactions dates from 1984. For years before 1985, the law was more complicated and less clear. Before 1985, § 1091(a) exempted corporate dealers in securities under the same conditions as present law, and losses incurred by corporations in trading in securities were clearly subject to § 1091(a). See Donander Co. v. CIR, 29 BTA 312 (1933) (corporation engaged in buying and selling securities for its own account was not dealer in securities within meaning of predecessor of § 1091). For taxpayers other than corporations, the pre-1985 § 1091(a) only disallowed losses otherwise deductible under § 165(c)(2) (relating to losses on transactions entered into for profit), not losses qualifying for deduction under § 165(c)(1) (relating to losses incurred in the taxpayer's trade or business). In 1930, the IRS ruled that an individual member of a stock exchange whose trading in securities for his own account was sufficient to be a trade or business was not subject to § 1091, but in 1971 the ruling was declared "obsolete" and not determinative as to future transactions. IT 2523, IX-1 CB 145 (1930), declared obsolete by Rev. Rul. 71-242, 1971-1 CB 423. The status of noncorporate traders in securities thus was unclear until the 1984 amendment. See Staff of Joint Comm. on Tax'n, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 321 (Comm. Print 1984) (before 1984 amendment, "the wash sale rule did not apply to noncorporate taxpayers who were in a trade or business of trading in stocks or securities"); Shine, Wash Sale Losses—A Gift to Securities "Traders," 32 Taxes 445 (1954). Currently, only dealer transactions are excluded, and traders thus are covered by § 1091(a), whether or not their trading is a trade or business and whether they are corporations or individuals.

Although § 165(c)(2) refers to "individuals," wash sales by trusts and estates were evidently covered by the pre-1985 § 1091(a). See Reg. § 1.1091-1(a) (last sentence) (implying that all taxpayers other than corporations were treated alike); Kunau v. CIR, 27 BTA 509 (1933) (acq.) (§ 1091 would have been applicable, but trust carried on trade or business of buying securities).

9 See infra ¶ 105.8.6.

10 HR Rep. No. 1388, 67th Cong., 4th Sess. 2–3 (1923). See 65 Cong. Rec. 7604 (1924) (remarks of Sen. Reed) ("stock market thrown into a state of mild convulsions" by transactions to realize paper losses).

11 See Rev. Rul. 71-316, 1971-2 CB 311.

12 See infra ¶ 44.8.6.

13 See infra ¶ 44.8.2.

14 See infra ¶ 44.8.3.

15 See infra ¶ 44.8.4.

16 See infra ¶ 44.8.5.

16.1 The IRS will not treat a redemption of shares in a money market fund (MMF) as a wash sale if the MMF is (1) an investment company registered under the Investment Company Act of 1940, (2) regulated as an MMF under Rule 2a–7 of the Securities and Exchange Commission and holds itself out to investors as an MMF, and (3) a floating-net asset value (NAV) MMF. Rev. Proc. 2014-45, 2014-34 IRB 388.

17 See infra ¶ 49.2. But see Rev. Rul. 59-418, 1959-2 CB 184 (date of contract to sell controlling, despite delayed delivery, apparently solely for tax reasons).

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18 Reg. § 1.1091-1(g). For background, see Doyle v. CIR, 286 F2d 654 (7th Cir. 1961) ; Frankel, Use of "Doyle Plan" Still Dangerous Despite Claims as Wash Sales "Loophole," 21 J. Tax'n 144 (1964). For short sales, see infra ¶ 57.7.1. See also IRC § 1091(e), discussed infra ¶ 44.8.5.

19 See infra ¶ 46.2.2.

20 But see infra ¶ 44.8.6.

21 Rev. Rul. 73-329, 1973-2 CB 302.

22 But see Rev. Rul. 71-520, 1971-2 CB 311 (§ 1091 triggered by exercise of stock subscription rights and sale within 30 days of identical shares).

23 See Estroff's Est. v. CIR, 47 TCM (CCH) 234 (1983) (loss disallowed under § 1091 on sale subject to repurchase contract; alternatively, sale was sham). But see US v. Regan, 937 F2d 823 (2d Cir. 1991) (defendants convicted of tax fraud for deducting losses on sales of securities to brokers under agreements obligating them to repurchase securities at fixed prices; held, conviction reversed because trial court had not instructed jury that good faith belief in allowability of deductions was defense to charge).

24 See Rev. Rul. 56-406, 1956-2 CB 523 (stock purchase warrants are options within meaning of § 1091). Section 1091(f), added in 2000, states that § 1091 "shall not fail to apply to a contract or option to acquire or sell stock or securities solely by reason of the fact that the contract or option settles in (or could be settled in) cash or property other than such stock or securities," and that "[t]hus, for example, the acquisition, within the period set forth in section 1091, of a securities futures contract to acquire stock of a corporation could cause the taxpayer's loss on the sale of stock in that corporation to be disallowed, notwithstanding that the contract may be settled in cash." HR Rep. No. 1033, 106th Cong., 2d Sess. 1034 (2000).

25 If the call is not exercised, the taxpayer is allowed a deduction when the option lapses equal to the call's adjusted basis, which, under § 1091(d), is the sum of the loss disallowed by § 1091(a) and the call premium. If the option is exercised, no gain or loss is recognized with respect to the call, and the disallowed loss becomes part of the basis of the securities acquired on exercise, which is the sum of the call's basis and the exercise price. See Estes, Selected Holding Period and Timing Problems and Opportunities of Investors in Securities—Possibilities for the Utilization of Put and Call Options, 24 Tul. Tax Inst. 66, 76–78 (1975).

26 Rev. Rul. 56-452, 1956-2 CB 525. According to the ruling, the option is "entered into" by the employee, within the meaning of § 1091(a), when it is granted by the employer. This stretches the language a bit, but not much more than holding that a purchaser of an existing option has "entered into" it, an event that is clearly covered by § 1091(a).

27 Rev. Rul. 85-87, 1985-1 CB 268, 269 (put treated as contract to purchase if, when put sold, there is "no substantial likelihood that the put would not be exercised").

27.1 Security First Nat'l Bank v. CIR, 28 BTA 289 (1933) (acq. & nonacq.).

27.2 Security First Nat'l Bank, 28 BTA at 314–315 (1933).

27.3 Rev. Rul. 2008-5, 2008-3 IRB 271.

28 Rev. Rul. 56-602, 1956-2 CB 527.

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29 Hanlin v. CIR, 108 F2d 429, 430 (3d Cir. 1939) (bonds of same issuer were substantially identical despite minor differences in maturity dates). For use of the term "substantially identical" in a similar context, see § 1233(b) (relating to short sales); Reg. § 1.1233-1(d)(1) (adopting term's meaning under § 1091).

30 Rev. Rul. 58-211, 1958-1 CB 529 (two series of Treasury bonds are substantially identical despite six-month difference in earliest call dates and in maturity dates, where these dates were six and nine years, respectively, in the future; difference between registered and bearer bonds immaterial, since owner could exchange one type for other; differences in issue and interest payment dates are immaterial). See Rev. Rul. 58-210, 1958-1 CB 523 (Treasury bonds that can be applied at par in payment of federal estate tax and are not eligible for unrestricted investment by commercial banks are not substantially identical to Treasury bonds without these features).

In IT 2672, XII-1 CB 72 (1933), securities were found not substantially identical because their maturity dates were three years and five months apart, 45 to 48 years in the future. This situation is described by Revenue Ruling 58-210 as "borderline," and IT 2672 was subsequently declared obsolete. Rev. Rul. 69-43, 1969-1 CB 310.

31 See Rev. Rul. 76-346, 1976-2 CB 247 (6.375 percent Treasury bonds maturing in 1982, not redeemable at par in payment of federal estate taxes, not substantially identical to 4.25 percent Treasury bonds maturing in 1992 and redeemable at par in payment of estate taxes); Rev. Rul. 60-195, 1960-1 CB 300 (3.45 percent bonds not substantially identical to 4.5 percent bonds).

32 See Kidder v. CIR, 30 BTA 59 (1934) (voting trust certificates substantially identical to underlying stock, at least where trust was created voluntarily by shareholders rather than by corporation); IT 2585, X-2 CB 182 (1931) (Class A and common stock of same corporation not substantially identical because latter class had exclusive voting rights), which was rather surprisingly declared obsolete and not determinative as to future transactions by Rev. Rul. 72-347, 1972-2 CB 648.

33 See Reg. § 1.1233-1(d)(1); Rev. Rul. 77-201, 1977-1 CB 250 (convertible security is "option" to acquire securities into which it is convertible); Rev. Rul. 56-406, 1956-2 CB 523 (stock warrant is option to acquire securities; whether replacement common stock is substantially identical to stock warrants sold by taxpayer at a loss depends on relative values and price changes).

34 See Hanlin v. CIR, 108 F2d 429, 430 (3d Cir. 1939) (bonds of different local federal land banks not substantially identical despite secondary liability on each other's bonds); Rev. Rul. 59-44, 1959-1 CB 205 (bonds of different local housing authorities are not substantially identical, despite federal guaranty of all bonds).

35 See Reg. § 1.1233-1(d)(1).

36 See Emmel, Wash Sales and Stock Options: How Does the "Substantially Identical" Rule Apply? 42 Tax Law. 1073 (1989).

37 Reg. §§ 1.1091-1(b)–1.1091-1(d).

38 IRC §§ 1091(d), 1223(4). See infra ¶ 49.4.

39 Reg. § 1.1091-1(h).

40 Section 1091(e) applies to losses realized after July 18, 1984. The reference to securities futures contracts was added in 2002, effective as of December 21, 2000. Pub. L. No. 107-147, § 412(d)(2), 116 Stat. 21 (2002). See infra ¶ 57.6.2 Fn 25.

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41 See infra ¶ 78.1.

42 See US v. Siegel, 472 F. Supp. 440 (ND Ill. 1979), aff'd sub nom. US v. Winograd, 656 F2d 279 (7th Cir. 1981), cert. denied, 455 US 989 (1982) (rigged wash sales in commodity futures were criminal fraud); Stein v. CIR, 36 TCM (CCH) 992 (1977) (loss disallowed on sale of securities to friend, who sold them back to taxpayer 33 days later; arrangement for repurchase was tantamount to "option" within meaning of § 1091; alternative ground, transaction lacked economic substance); Clark v. CIR, 2 BTA 555 (1925) (acq.) (sale on eve of enactment of predecessor of § 1091; loss disallowed, since buyer was employee, described by court as an "accommodation purchaser"). See supra ¶ 4.3 (form vs. substance, business purpose, and step transaction doctrines); infra ¶ 78.1.1 (status of transactions not explicitly covered by § 267).

43 See IT 1239, I-1 CB 149 (1922) (gain realized on wash sales is recognized), declared obsolete and not determinative as to future transactions by Rev. Rul. 69-43, 1969-1 CB 310.

44 Horne v. CIR, 5 TC 250 (1945) (membership on commodity exchange).

45 The legislative history reflects an assumption that a spread of more than 30 days immunizes the transaction. HR Rep. No. 1388, 67th Cong., 4th Sess. (1923). It was probably not intended, however, that loss be allowed when, for example, the vendee is only an accommodation party who is obligated to resell the securities to the taxpayer on request. Indeed, concealment of such an agreement may be civil or criminal fraud. See Shoenberg v. CIR, 77 F2d 446, 449 (8th Cir.), cert. denied, 296 US 586 (1935) (sale and repurchase outside the period specified by § 1091; loss disallowed because, "for all practical purposes," taxpayer used the vendee, a controlled corporation, "as an agency for purchasing, holding, and selling to him, stocks identical with those he sold to establish the claimed loss"); CIR v. Dyer, 74 F2d 685 (2d Cir.), cert. denied, 296 US 586 (1935) (same); Rev. Rul. 72-225, 1972-1 CB 59 (sale subject to oral repurchase option not bona fide, without regard to § 1091). But see US v. Regan, 937 F2d 823 (2d Cir. 1991) (reversing tax fraud conviction of defendants who deducted losses on sales of securities under agreements obligating them to repurchase securities at fixed prices; trial court failed to instruct jury that good faith belief in allowability of deductions was defense to charge).

46 See Brochon v. CIR, 30 BTA 404 (1934) (sale by husband and repurchase by wife, with payment guaranteed by husband; held, sale not bona fide, or, if it was, taxpayer was both seller and purchaser within meaning of § 1091).

47 See IRC § 1091(d), discussed supra ¶ 44.8.4; IRC § 267(d), discussed infra ¶ 78.1.3.

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CHECKPOINT

Ajay Gupta
Financial Products Taxation
Reading #7

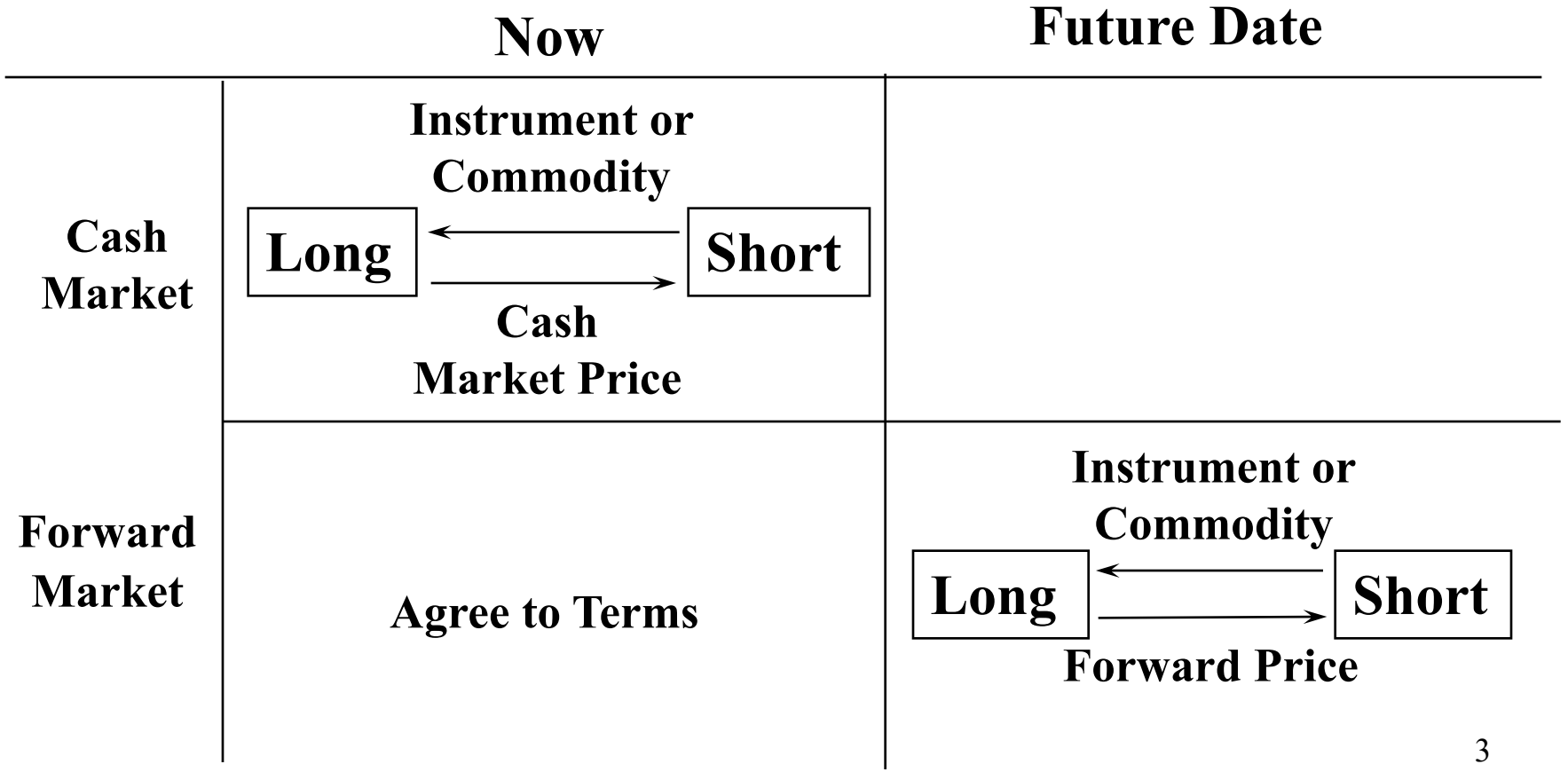
Forwards & Futures

Derivatives

- A derivative is a financial security that is a claim on another security or underlying asset.
- Derivatives can be used to speculate on price changes in attempts to gain profit, or they can be used to hedge against price changes in attempts to reduce risk.
- Examples of derivatives are forwards, futures, and options.

Forward Contract

Obligates one party to buy and another party to sell an underlying instrument or commodity at a future date



Forward Contract

- Forward is just a contract to deliver at a future date (exercise date or maturity date) at a specified exercise price.
- Example: Rice farmer sells rice to rice processor.
- Example: Foreign Exchange (FX) forward. Contract to sell £ for ¥.
- Both sides are locked into the contract, no liquidity.

Example: Farmer in Iowa

- Farmer in March is planting crop expected to yield 50,000 bushels of corn. By this business, farmer is "long" 50,000 bushels.
- Farmer sells ten forward Chicago September corn contracts for 5,000 bushels each, at $2.00 a bushel. By this transaction, farmer is entitled to receive $2.00*50,000 = $100,000.
- Corn products manufacturer plans to buy corn at harvest time. It buys the ten forward contracts.
- Come September, both buyer and seller close out their respective positions.

Forward Price

- The delivery price, X, cannot change because it is written into the contract. But the forward price, F, may change after the contract comes into existence.
- The value of a forward contract, f, is 0 at the outset, or at $t = 0$.
- It will fluctuate thereafter with the spot price, S_t, increasing when the spot price increases and declining when the spot price declines.
- The value of a forward contract will also generally decline as expiration approaches.

Forward Price

- The payoff of a forward contract at maturity is:

$$S_T - X,$$

  where S_T is the spot price at maturity

- Forward contracts do not involve any initial cash flow.

- The forward price is the delivery price that makes the forward contract zero valued at inception. That is, $f_0 = 0$, when $X = F_0$.

Forward Price

Forward price is the current spot price of the underlying asset, plus any carrying costs such as interest, storage costs, foregone interest or other costs or opportunity costs.

Forward Price

- r_t = interest rate per unit of time
- u_t = storage cost per unit of time
- $(r_t + u_t)$ = cost of carry per unit of time
- $T - t$ = time to maturity
- $(r_t + s_t)*(T - t)$ = cost of carry until maturity

$$F_t = S_t*(1 + (r_t + u_t)*(T - t))$$

Fair Value of Forward Contract

Although the forward has no intrinsic value at inception, over time, a contract may gain or lose value, as the spot price moves, the interest rate and storage cost change, and expiration approaches.

$$F_t = S_t * (1 + (r_t + u_t) * (T - t))$$

FX Forwards and Forward Interest Parity

- FX Forward is like a pair of zero-coupon bonds.
- Therefore, forward rate reflects interest rates in the two currencies
- Forward Interest Parity:

$$\text{forward exchange rate (Y/\$)} = \text{spot exchange rate (Y/\$)} \times \frac{1 + r_Y}{1 + r_\$}$$

Problem with Forwards: Default

- Farmer and corn products manufacturer must check each others' creditworthiness
- Forward contracts are inherently credit instruments.
- Only people with good credit can use them.

Futures Contracts

- Futures contracts differ from forward contracts in that contractors deal with an exchange rather than each other, and thus do not need to assess each others' credit.
- Futures contracts are standardized retail products, rather than custom products.
- Futures contracts rely on margin calls to guarantee performance.

First Futures Market: Osaka

- Begun at Dojima, Osaka, Japan, in 1670s. World's only futures market until 1860s.
- Dojima was center for rice trade, with 91 rice warehouses in 1673.
- Dojima futures exchange had precise definitions of quality, delivery date and place, experts who evaluated rice quality, and clearinghouses for contracts.

Function of Osaka Futures Market

- Japan had sophisticated financial contracts before the futures market, partly under influence of Dutch.
- Rice bills and silver bills were kinds of forward contracts.
- Osaka market provided liquidity and price discovery for rice, thus allowing merchants to hedge risk.

Buying or Selling Futures

- When one “buys” a futures contract, one agrees with the exchange to a daily settlement procedure that is only loosely analogous to buying the commodity. One must post initial margin with the futures commission merchant.
- Usually, one has no intention of taking delivery of the commodity
- Same as when one “sells” a futures contract, one doesn’t intend selling the commodity. Again, post margin.

Daily Settlement

- Every day, the exchange defines a price called the "settlement" price, which is essentially the last trade on that day.
- Every day until expiration, a buyer's margin account is credited (or debited if negative) with the amount: change in settlement price*contract amount.
- If contract is cash settled, on the last day, the margin account is credited with: (cash settlement price − last settlement price)*contract amount.
- If contract is physical delivery, on the last day, buyer must receive commodity.

Futures Prices

- Futures contracts give the buyer the change in the futures price computed every day up to the time the position is closed.
- At the end of each day, after the contract is marked to market, the value of the contract is zero.
- If interest rates are certain, then futures and forward prices are equal.

Futures v. Forwards

- Futures contracts are traded on a central exchange.
- Clearinghouse minimizes credit risk.
- Futures contracts are standardized instruments.
- Gains and losses are marked to market daily. Adjusted at the end of each trading day based on the settlement price.

Size of a Futures Contract

- The amount of the underlying asset to be delivered under the contract.
  - 5,000 bushels for the corn futures on the CBT.
  - One million U.S. dollars for the Eurodollar futures on the CME.
- A position can be closed out (or offset) by entering into a reversing trade to the original one.
- Most futures contracts are closed out in this way rather than having the underlying asset delivered.
  - Forward contracts are meant for delivery.

Daily Settlements

- Price changes in a futures contract are settled daily.
- Hence the spot price rather than the initial futures price is paid on the delivery date.
- Marking to market nullifies any financial incentive for not making delivery.
  - A farmer enters into a forward contract to sell to a corn food processor 50,000 bushels of corn at $2.00 per bushel in September.
  - Suppose the price of corn rises to $2.50 by September.

Daily Settlements

- The farmer now has incentive to sell his harvest in the spot market at $2.50.
- With marking to market, the farmer has transferred $0.50 per bushel from his futures account to that of the food processor by November.
- When the farmer makes delivery, he is paid the spot price, $2.50 per bushel.
- The farmer has little incentive to default.
- The net price remains $2.00 per bushel, the original delivery price.

Delivery and Hedging

- Delivery ties the futures price to the spot price.
- On the delivery date, the settlement price of the futures contract is determined by the spot price.
- Hence, as the delivery date approaches, the futures price converges to the spot price.
- Changes in futures prices usually track those in spot prices.
- This makes hedging possible.

Arbitrage Enforcing Fair Value

- Arbitrage opportunities arise if the forward (futures) price is too high relative to the spot price.
- In particular, the forward (futures) price should always be bounded above by the spot price plus the cost of carry until maturity.

Arbitrage Enforcing Fair Value

- For a commodity that can be sold short, arbitrage opportunities arise if the forward (futures) price is too low relative to the spot price.
- In particular, the forward (futures) price should always be bounded below by the spot price plus the cost of carry until maturity.

Arbitrage Enforcing Fair Value

$$F_t = S_t * (1 + (r_t + u_t) * (T - t))$$

The forward (futures) price is equal to the spot price plus the cost of carry until maturity.

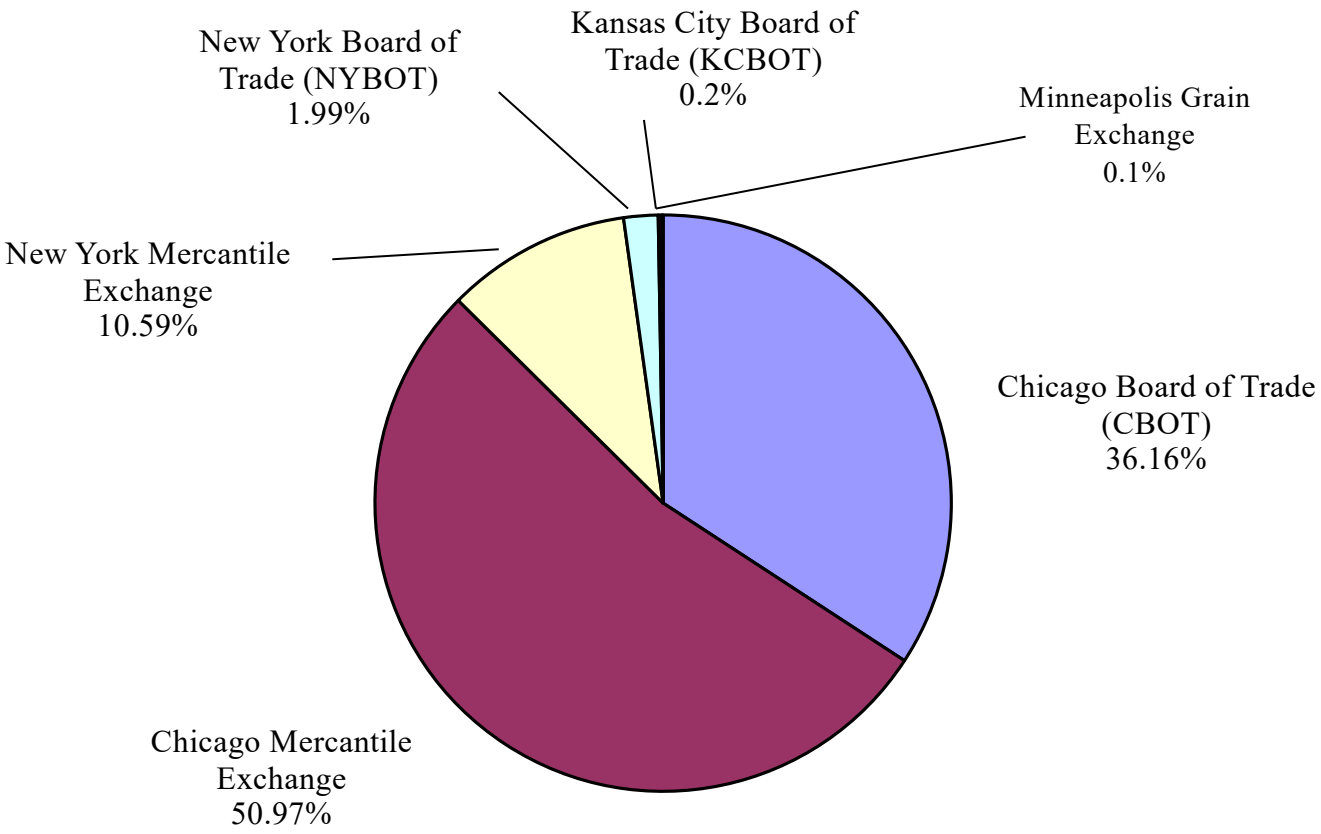
From Agricultural Futures to Financial Futures

- Financial futures markets began in the US in the 1970s.
- Same concepts of fair value, hedging, and arbitrage.

United States Futures Exchanges

- Big Three:
  - CBOT: Open outcry and electronic trading (e-cbot)
  - Chicago Mercantile Exchange: Foreign currencies expertise. Electronic system (GLOBEX)
  - New York Mercantile Exchange: Specialized in energy and metals.

United States Futures Exchanges



Ajay Gupta
Financial Products Taxation

Reading #8

The Basics of Financial Options

Main Issues

- Introduction to Options
- Use of Options
- Properties of Option Prices

1 Introduction to Options

1.1 Definitions

Option types:

Call: Gives owner the right to purchase an asset (the underlying asset) for a given price (exercise price) on or before a given date (expiration date).

Put: Gives owner the right to sell an asset for a given price on or before the expiration date.

Exercise styles:

European: Gives owner the right to exercise the option only on the expiration date.

American: Gives owner the right to exercise the option on or before the expiration date.

Key elements in defining an option:

- Underlying asset and its price S
- Exercise price (strike price) K
- Expiration date (maturity date) T (today is 0)
- European or American.

1.2 Option Payoff

The payoff of an option on the expiration date is determined by the price of the underlying asset.

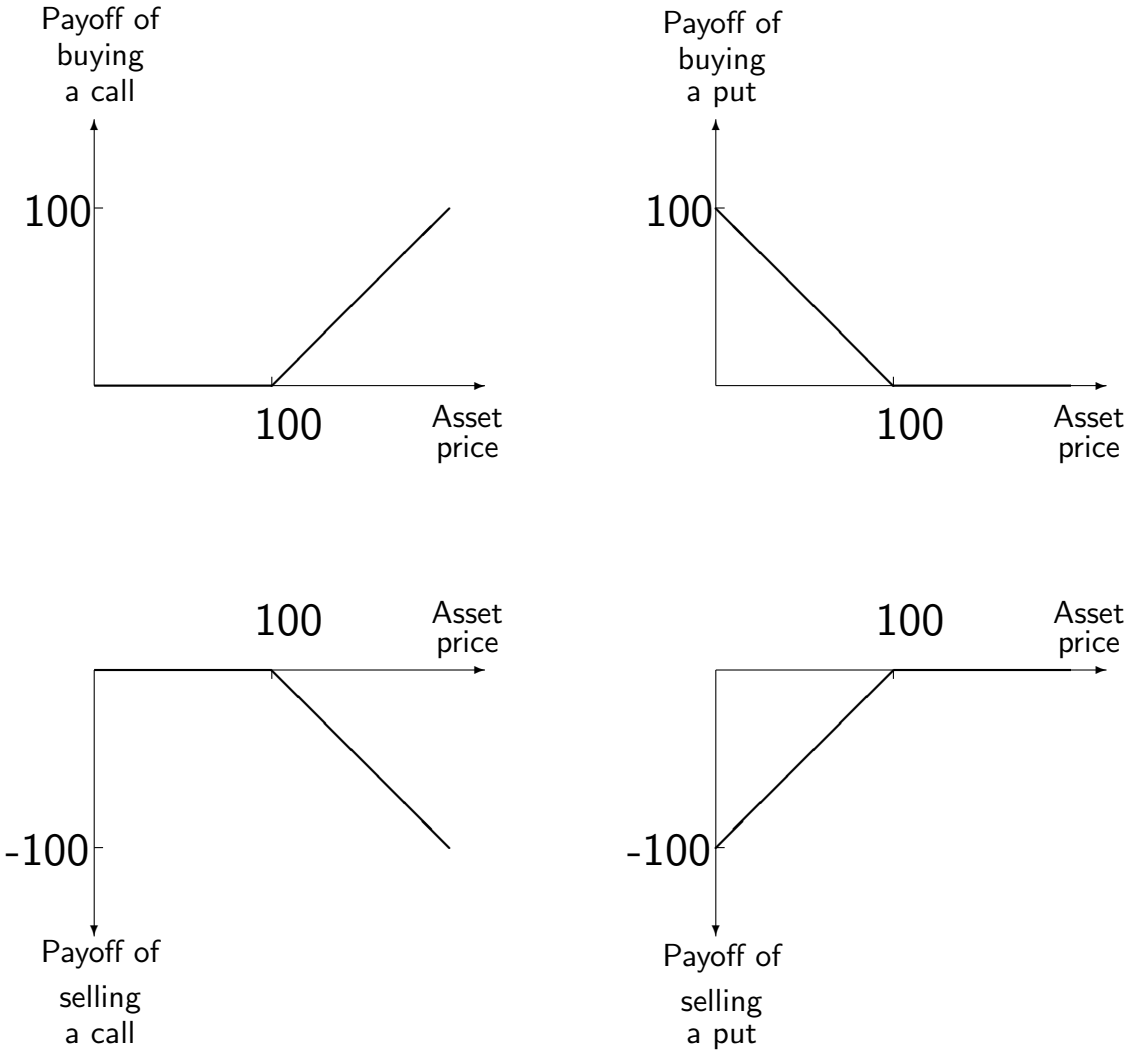
Example. Consider a European call option on IBM with exercise price \$100. This gives the owner (buyer) of the option the right (not the obligation) to buy one share of IBM at \$100 on the expiration date. Depending on the share price of IBM on the expiration date, the option owner's payoff looks as follows:

IBM Price	Action	Payoff
⋮	Not Exercise	0
80	Not Exercise	0
90	Not Exercise	0
100	Not Exercise	0
110	Exercise	10
120	Exercise	20
130	Exercise	30
⋮	Exercise	$S_T - 100$

Note:

- The payoff of an option is never negative.
- Sometimes, it is positive.
- Actual payoff depends on the price of the underlying asset.

- Payoffs of calls and puts can be described by plotting their payoffs at expiration as function of the price of the underlying asset:

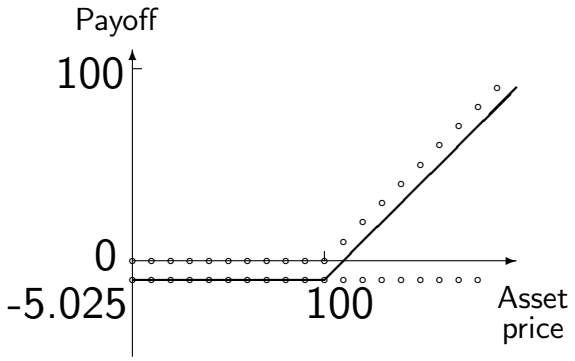


The net payoff from an option must include its cost.

Example. A European call on IBM shares with an exercise price of \$100 and maturity of three months is trading at \$5. The 3-month interest rate, not annualized, is 0.5%. What is the price of IBM that makes the call break-even?

At maturity, the call's net payoff is as follows:

IBM Price	Action	Payoff	Net payoff
⋮	Not Exercise	0	- 5.025
80	Not Exercise	0	- 5.025
90	Not Exercise	0	- 5.025
100	Not Exercise	0	- 5.025
110	Exercise	10	4.975
120	Exercise	20	14.975
130	Exercise	30	24.975
⋮	Exercise	$S_T - 100$	$S_T - 100 - 5.25$



The break even point is given by:

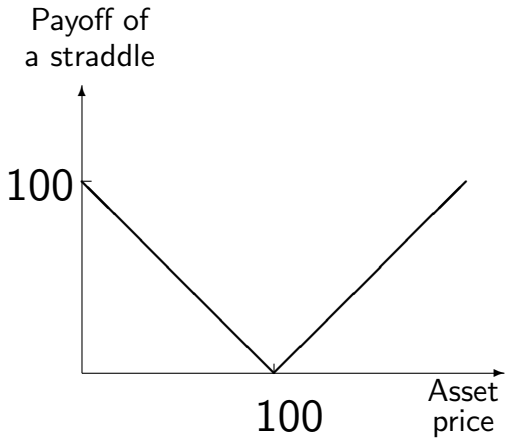
$$\text{Net payoff} = S_T - 100 - (5)(1 + 0.005) = 0$$

or

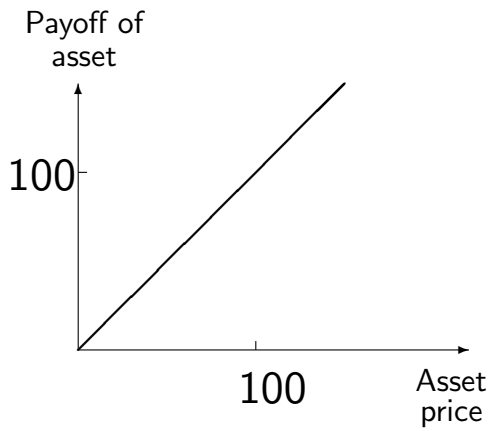
$$S_T = \$105.025.$$

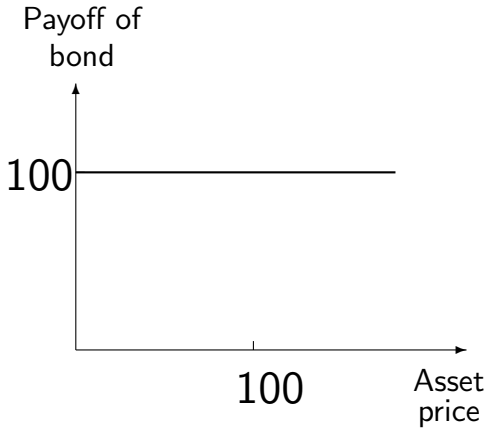
Using the payoff diagrams, we can also examine the payoff of a portfolio consisting of options as well as other assets.

Example. Consider the following portfolio (a straddle): buy one call and one put (with the same exercise price). Its payoff is:



Example. The underlying asset and the bond (with face value \$100) have the following payoff diagram:





1.3 Corporate Securities as Options

Example. Consider two firms, A and B, with identical assets but different capital structures (in market value terms).

Balance sheet of A

Asset	\$30	\$0	Bond
		30	Equity
	\$30	\$30	

Balance sheet of B

Asset	\$30	\$25	Bond
		5	Equity
	\$30	\$30	

- Firm B's bond has a face value of \$50. Thus default is likely.
- Consider the value of stock A, stock B, and a call on the underlying asset of firm B with an exercise price \$50:

Asset Value	Value of Stock A	Value of Stock B	Value of Call
\$20	20	0	0
40	40	0	0
50	50	0	0
60	60	10	10
80	80	30	30
100	100	50	50

- Stock B gives exactly the same payoff as a call option written on its asset.
- Thus B's common stocks really are call options.

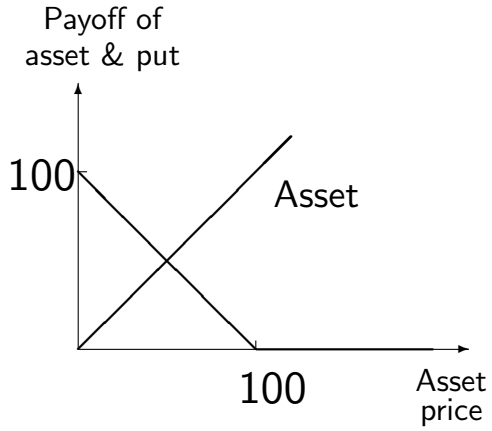
Indeed, many corporate securities can be viewed as options:

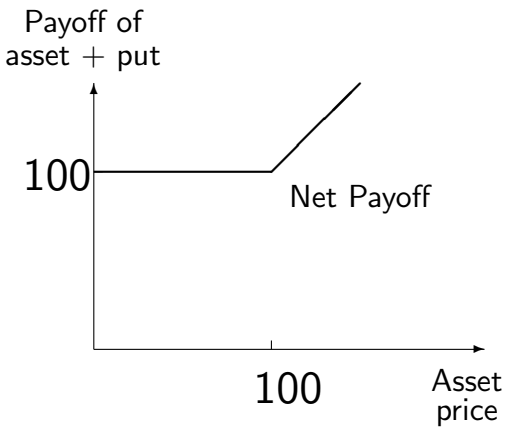
Common Stock:	A call option on the assets of the firm with the exercise price being its bond's redemption value.
Bond:	A portfolio combining the firm's assets and a short position in the call with exercise price equal bond redemption value.
Warrant:	Call options on the stock issued by the firm.
Convertible bond:	A portfolio combining straight bonds and a call option on the firm's stock with the exercise price related to the conversion ratio.
Callable bond:	A portfolio combining straight bonds and a call written on the bonds.

2 Use of Options

Hedging Downside while Keeping Upside.

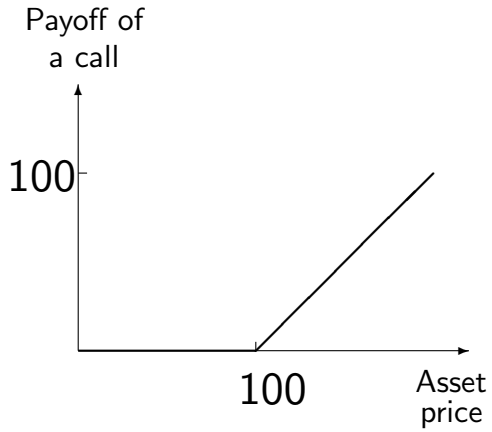
The put option allows one to hedge the downside risk of an asset.

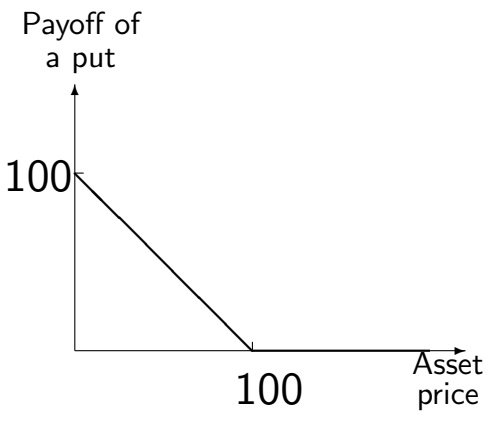




Speculating on Changes in Prices

Buying puts (calls) is a convenient way of speculating on decreases (increases) in the price of the underlying asset. Options require only a small initial investment.





3 Properties of Options

For convenience, we refer to the underlying asset as stock. It could also be a bond, foreign currency or some other asset.

Notation:

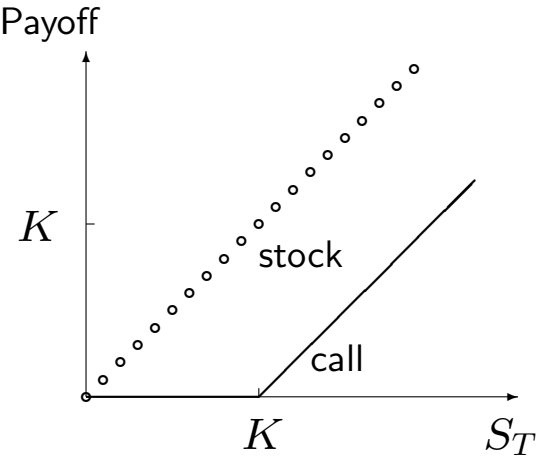
- S: Price of stock now
- S_T: Price of stock at T
- B: Price of discount bond with face value \$1 and maturity T (clearly, $B \leq 1$)
- C: Price of a European call with strike price K and maturity T
- P: Price of a European put with strike price K and maturity T
- c: Price of an American call with strike price K and maturity T
- p: Price of an American put with strike price K and maturity T.

Price Bounds

First consider European options on a non-dividend paying stock.

1. $C \geq 0$.

2. $C \leq S$ — The payoff of stock dominates that of call:

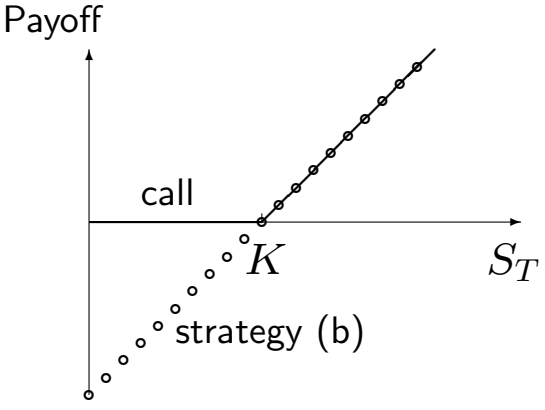


3. $C \geq S - KB$ (assuming no dividends).

   Strategy (a): Buy a call

   Strategy (b): Buy a share of stock by borrowing KB.

   The payoff of strategy (a) dominates that of strategy (b):

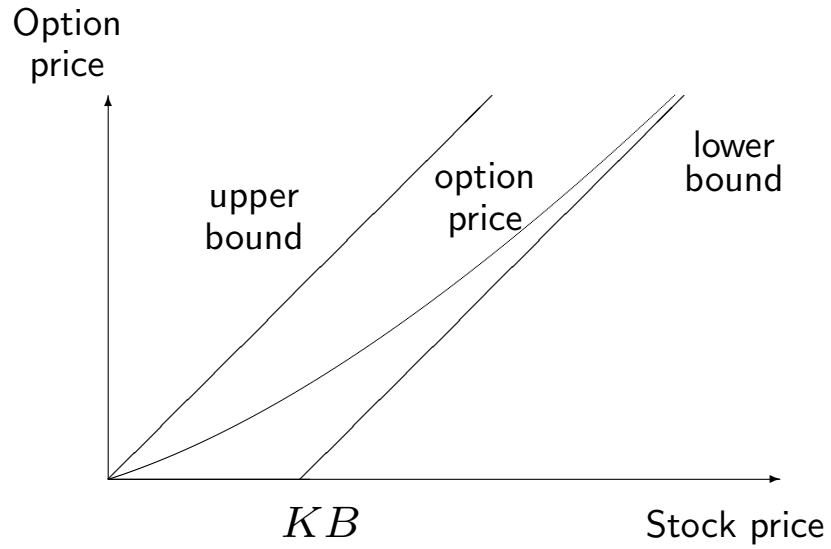


Since $C \geq 0$, we have

$$C \geq \max[S - KB,\ 0].$$

4. Combining the above, we have

$$\max[S - KB,\ 0] \leq C \leq S.$$

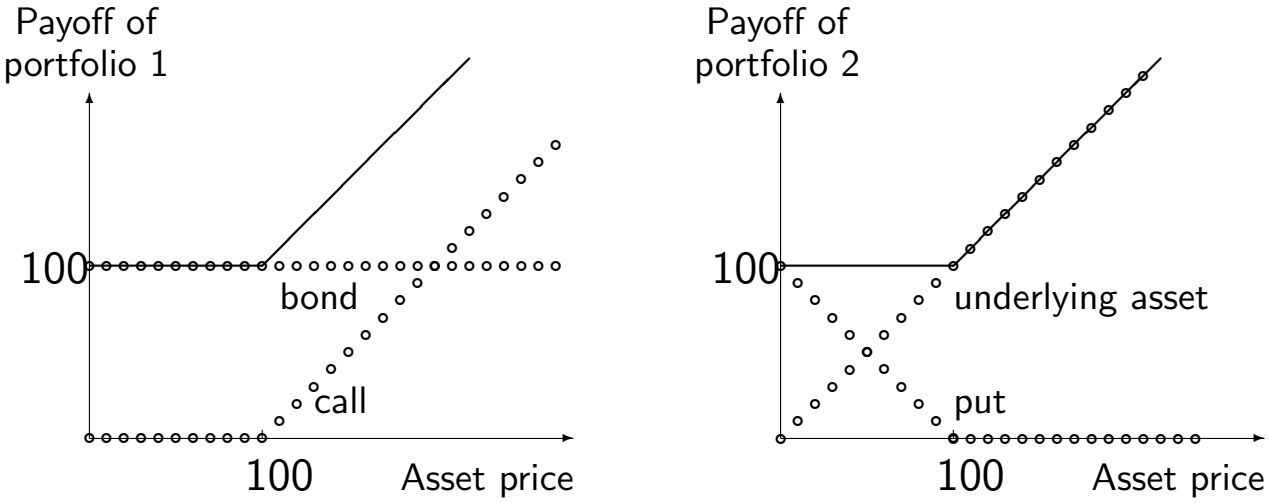


Put-Call Parity

Consider the following two portfolios:

1. A portfolio of a call with exercise price \$100 and a bond with face value \$100.
2. A portfolio of a put with exercise price \$100 and a share of the underlying asset.

Their payoffs are



Their payoffs are identical, so must be their prices:

$$C + K/(1+r)^T = P + S.$$

This is called put-call parity.

American Options and Early Exercise

1. American options are worth more than their European counterparts.

2. Without dividends, never exercise an American call early.
   - Exercising prematurely requires paying the exercise price early, hence losing the time value of money.
   - Exercising prematurely foregoes the option value

     $$c(S, K, T) = C(S, K, T).$$

3. Without dividends, it can be optimal to exercise an American put early.

   Example. A put with strike \$10 on a stock with price zero.
   - Exercise now gives \$10 today
   - Exercise later gives \$10 later.

Effect of Dividends

1. With dividends,

   $$\max[S - KB - PV(D),\ 0] \leq C \leq S.$$

2. Dividends make early exercise more likely for American calls and less likely for American puts.

Option Value and Asset Volatility

Option value increases with the volatility of underlying asset.

Example. Two firms, A and B, with the same current price of \$100. B has higher volatility of future prices. Consider call options written on A and B, respectively, with the same exercise price \$100.

	Good state	bad state
Probability	p	$1-p$
Stock A	120	80
Stock B	150	50
Call on A	20	0
Call on B	50	0

Clearly, call on stock B should be more valuable.

Ajay Gupta
Financial Products Taxation
Reading #9

Treatment of Options

Code: § 1234

Treatise: Keyes, Federal Taxation of Financial Instruments & Transactions, Chapter 12, Overview of Options and the Options Market, ¶12.02 (Attached).

Problems:

1. The stock price of ABC, Inc., traded on the New York Stock exchange, today, Thursday, March 9, 2023, is $900.

A European call option on this stock with a strike price of $900 and three-month maturity will give the holder the option to buy the stock at $900 on Friday, June 9, 2023. Suppose this call option trades today at $65.

A European put option on this stock with a strike price of $900 and three-month maturity will give the holder the option to sell the stock at $900 on Friday, June 9, 2023. Will this put option trade today for: (a) more than $65; (b) less than $65; or (c) exactly $65? Why? (If it helps, you may assume that the risk-free rate of interest is 2% per annum.)

2. In November 2021, the New York Yankees announced that they would decline their $3 million club option on Joely Rodríguez for the 2022 season. Instead, the left-hander received a $500,000 buyout and entered free agency. A few days later, Rodríguez and the Yankees agreed to a $2 million, one-year contract. (In April 2022, the Yankees traded Rodríguez to the New York Mets for Miguel Castro.)

In November 2022, Rodríguez agreed to a one-year contract with the Boston Red Sox, a deal that included a club option for the 2024 season. Under the contract, Rodríguez gets a $1.5 million salary for the 2023 season, and the Red Sox's option is for $4.25 million with a $500,000 buyout.

A club option is an optional year at the end of a player's contract. In other words, the club can choose to keep the player on its team for an additional year for a guaranteed salary. Alternatively, the club can decline and pay the player a predetermined buyout price.

Can a baseball club option, like the one that the Yankees had on Rodríguez, and like the one that the Red Sox now have on him, be analyzed as a financial option? If so, what sort of option is this, and what is the option premium, the exercise price, and the payoff?

THOMSON REUTERS
CHECKPOINT

Fed. Tax. Fin. Instruments & Transactions ¶ 12.02

***1 Federal Taxation of Financial Instruments & Transactions**

October 2020

Keyes

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Part III. Derivatives and Other Financial Instruments

Chapter 12. Treatment of Options

12.02 OVERVIEW OF OPTIONS AND THE OPTIONS MARKET

Section 1234 applies to options to buy property (calls) and options to sell property (puts). These options and certain of their variations are discussed below along with certain concepts that apply to options. The peculiar mechanics of exchange-traded options are also covered briefly.

12.02[1] Definition of "Option" and Nomenclature

In general, 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. The consideration received by the grantor for writing (selling) the option is referred to as the option "premium," and the price at which the property is to be sold is the "exercise price" or "strike price" of the option.[7] The grantor of the option may be referred to alternatively as the "writer" or "seller" of the option, while the holder may also be referred to as the "purchaser" or "buyer" of the option. Finally, the writer of the option is said to be in a "short" position, while the holder is said to be in a "long" position with respect to the option, whether it is a put or call option.

Courts have stated that an option has historically required (1) a continuing offer to do an act, or to forbear from doing an act, which does not ripen into a contract until accepted, and (2) an agreement to leave the offer open for a specified or reasonable period.[7.1] Courts have also noted that the primary legal effect of an option is that it limits the grantor's power to revoke his or her offer, and creates an unconditional power of acceptance in the holder.[7.2] The Tax Court has distinguished an option from a contract of sale by noting that an option gives a person a right to purchase property at a fixed price within a limited period but imposes no obligation on the person to do so, whereas a contract of sale contains mutual and reciprocal obligations, the seller being obligated to sell and the purchaser being obligated to buy. If the holder does not exercise the option, the grantor is entitled to keep the consideration received for granting the option, but has no enforceable right against the option holder for damages. In contrast, in a contract for sale, the holder will be liable for damages if he or she fails to perform.[7.3]

In *Federal Home Loan Mortgage Corp. v. Commissioner*,[7.4] the court addressed whether nonrefundable commitment fees that mortgage originators paid to the taxpayer to enter into conventional multifamily prior approval purchase contracts were to be recognized under Section 451 when the fees were paid or were to be treated as premiums for put options, which would

have deferred recognition until after the delivery or nondelivery of the underlying mortgages. The taxpayer argued that the nonrefundable portions of the fees that the originators paid to enter into the prior approval purchase contracts were put option premiums, the tax treatment of which was not to be determined until the originators either exercised the options or allowed them to lapse. The Service argued that the nonrefundable portions of the fees were not option premiums because the prior approval purchase contracts were not option contracts. The court, however, found that the taxpayer properly treated the nonrefundable portion of the commitment fees as option premiums because the terms and the economic substance of the prior approval purchase contracts indicated that the taxpayer and the originators entered into option contracts.

12.02[1][a] Call Options

***2** A purchaser of a call option obtains the right to purchase from the writer a specific quantity of property (e.g., a stated number of shares of stock) at a specified price, at any time on or before a specified future date. [8] Importantly, the holder is not obligated to purchase the underlying property under the option.

Example 12-1

Assume that Individual *A* acquires an option to purchase (call) 100 shares of stock in *ABC* Corporation for $30 a share. Under the call, *A* has the right, but not the obligation, to purchase 100 shares of *ABC* Corporation stock. If *A* exercises the option, the writer must deliver the specified number of shares. *A* will pay the strike price of $30 for each share. *A* pays a premium to the option writer for this right.

A holder of a call option normally would not exercise the option if the market value of the underlying stock were to fall below the price specified in the option (i.e., the option becomes "out-of-the money"). [9] The holder would usually allow the option to lapse instead, since the property could be acquired by the holder more cheaply in the market. On the other hand, if the market value of the underlying stock were to rise above the option strike price (i.e., the option becomes "in-the-money"), the holder would normally exercise the option before it lapses.

12.02[1][b] Put Options

A purchaser of a put option obtains the right to sell to the writer a stated quantity of property (e.g., a specific number of shares of stock) at a specified price, at any time on or before a specified future date. [10] As in the case of a call option, the holder of a put is not obligated to exercise the option.

Example 12-2

Assume that Individual *A* acquires an option to sell (put) 100 shares of ABC Corporation stock for $30 a share. Under the put, *A* has the right, but not the obligation, to sell 100 shares of ABC stock to the option writer. If *A* exercises the option, the writer is obligated to purchase the shares at the option strike price of $30. *A* pays a premium to the writer for this right.

If the value of the underlying stock were to rise above the price specified in the option contract (i.e., the option becomes "out-of-the-money"), the holder of the put normally would allow the option to lapse, since the holder could sell the property in the market at a higher price. On the other hand, if the value of the underlying property were to fall below the option strike price (i.e., the option becomes "in-the-money"), the holder most likely would exercise the put prior to its expiration. [11]

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12.02[1][c] Cash Settlement Options

"Cash settlement option" is defined for tax purposes as an option that, upon exercise, settles in (or could be settled in) cash or property other than the underlying property. [12] A common example of a cash settlement option is an option on a stock index. Unlike stock options, index options do not relate to a particular number of shares. Instead, the size or underlying value of an index option contract is determined by the index multiplier and the level of the underlying index. The exercise price of an index option is expressed in dollars. Thus, the total exercise price for a single index option is the stated exercise price multiplied by the applicable index multiplier. [13]

***3** If the index option is structured as a put option, the holder will receive payment if the value of the index is below the option strike price at exercise. If the index option is structured as a call, the holder would receive payment if the value of the index is higher than the strike price at exercise. Conversely, an option that is out-of-the-money at the time of expiration will expire worthless.

Example 12-3

Individual *A* acquires a call option on a narrow-based stock index. The option has a strike price of $90 and an index multiplier of 100. When the index value is 98, *A* exercises the call. Accordingly, *A* receives $800 upon exercise (($98 − $90) x $100).

The premium for an index option is expressed in terms of points, or fraction of points, with each point representing an amount equal to one dollar times the index multiplier. Thus, in Example 12-3, if the premium was quoted at $2, the total premium would be $200 ($2 quote x 100 multiplier).

12.02[1][d] Warrants

Options to acquire stock directly from the issuer are generally known as warrants. Except for being issued by the corporation itself, warrants are similar to call options on stock in that both provide the holder with the right to acquire a specific number of shares of stock at a specified price during a specified period. Detachable warrants are often issued with other securities, particularly debt instruments and stock, as compensation for a reduced interest or dividend rate. Once detached, the warrants can be traded in the secondary markets. [14]

12.02[1][e] Long-Term Equity Anticipation Securities

Most exchange-traded options have a maximum term of nine months. However, one type of option, referred to as "long-term equity anticipation securities" (LEAPS), has been introduced recently. These options generally have the same terms as normal exchange-traded options, except that their term to expiration is much longer than the usual option (e.g., two years). The use and trading strategies involving LEAPS are generally the same as normal traded options. Indeed, LEAPS that have a remaining term to maturity of less than nine months become ordinary options for trading purposes. [15]

12.02[1][f] American Versus European-Style Options

The period during which an option is exercisable depends on whether the option is characterized as an "American-style option" or an "European-style option." An American-style option is an option that may be exercised at any time after its purchase until

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the option expires. An European-style option, on the other hand, is an option that may be exercised only during a specified period (e.g., on a specific day). Index options described above [16] are often structured as European-style options.

12.02[1][g] The Intrinsic and Time Value of Options

The price of an option can be viewed as consisting of two possible elements—the intrinsic value of the option and its time value. The intrinsic value generally refers to the amount, if any, by which an option is "in-the-money." As indicated earlier, the intrinsic value of a put option is the amount by which the strike price of the option exceeds the value of the underlying property. Conversely, in the case of a call option, the intrinsic value is the amount by which the price of the underlying property exceeds the option's strike price.

Example 12-4

***4** Assume that the current trading price of *X* corporation is $49 a share, and Individual *A* holds an option to acquire that stock at $45 a share. The option has an intrinsic value of $4 a share. In contrast, if the value of the stock is $45, the option is said to be "at-the-money." If the value of the stock is below $45, the option is out-of-the-money. In either of the latter two cases, the option's intrinsic value is zero.

The portion of an option premium in excess of intrinsic value is the time value of the option. This value represents the price a person will pay for the option in the hope that at some time prior to expiration its value will increase because of a favorable change in the price of the underlying interest. [17] However, the underlying premise of time value is that an option can be exercised at any time as a means of realizing its intrinsic value. Accordingly, time value applies only to American-style options, not to European-style options (except during their exercise period). [18]

Thus, an American-style option with intrinsic value will often have some time value as well. That is, its premium often will be greater than its intrinsic value.

Example 12-5

In Example 12-4, if the value of the underlying stock were $49 and the option premium were $6 per share, the intrinsic value would be $4 and the time value would be $2. If the trading price of the stock were $45, the intrinsic value would be zero, yet a person might still pay a premium of say, $2, attributable solely to the time value of the option.

The time value of an option is influenced by several factors, the greatest being the period of time until expiration. In general, the time value of an option should decrease as the option approaches its expiration date. In light of this declining time value, an option is often said to be a "decaying" or "wasting" asset. The option will become worthless if not sold or exercised prior to its expiration. [19]

The time value of an option is also a function of the volatility of the underlying property. The more volatile the property, the greater the likelihood that the option will become in-the-money at some point before expiration. In addition, time value is also affected by the cost of money, since increases in prevailing interest rates tend to produce higher premiums. Finally, time value is also affected by the value of the property in relation to the strike price of the option. If the option is significantly in-the-money or out-of-the money, the time value is not likely to be as great. [20]

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12.02[2] The Advent of Exchange-Traded Options

Prior to the formation of the Chicago Board Options Exchange (CBOE) in 1973, option contracts were traded in the over-the-counter (OTC) markets. In general, OTC options are negotiated and entered into between a writer and a holder, with the dealer acting merely as an intermediary.[21] The writer and holder have a direct contractual relationship with each other. Thus, the writer is personally obligated to respond to the decision of a particular holder, and the holder can demand performance only from that particular writer.

***5** The creation of the CBOE, however, established a national exchange for options contracts. For the first time, investors and other market participants gained the ability to trade options on a regulated exchange. Standardized options were developed to facilitate trading and enhance liquidity. In addition, the Chicago Board Options Clearing Corporation (OCC) was formed to function as a clearinghouse for transactions executed on the CBOE. The presence of the OCC also facilitates trading and liquidity of options.

12.02[2][a] Options Exchanges

Stock options, index options, and debt options are generally traded on exchanges regulated by the Securities and Exchange Commission (SEC). In contrast, options on commodities and futures contracts (including options on stock index futures) are generally traded on exchanges regulated by the Commodity Futures Trading Commission (CFTC). The latter group of options is generally subject to tax under Section 1256. The discussion that follows focuses on exchange-traded stock options (as well as the CBOE, the largest of security options exchanges).

12.02[2][b] Standardized Options Contracts

Exchange-traded options have standardized terms whereby the contract size, exercise price, and expiration date of each contract is specified by the exchange on which the option is traded. Although the terms may be expressed differently, depending on the underlying property, the contract terms are nevertheless standardized with respect to each type of option.

In the case of a stock option,[22] the contract size is typically 100 shares of the underlying stock.[23] Strike prices are typically set at intervals of $2.50 for stocks trading under $25, $5 for stocks trading between $25 and $200, and $10 for stocks trading over $200. In addition, options typically expire on the Saturday following the third Friday of the expiration month. An example of a typical stock option traded on the CBOE is set forth below.

Example 12-6

An ABC/March/40 call gives the holder the right to purchase 100 shares of *ABC* stock at a price of $40 per share (or a total price of $4,000) at any time prior to the expiration of the option in March. The premium is generally quoted on a per-share basis. Thus, if the premium for the option was $3, the holder would pay $300 to the writer.

In most cases, call options are automatically exercised if the underlying stock closes at a designated price above the strike price unless there is specific instruction by the holder not to exercise.

12.02[2][c] Clearing Organizations

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A key advantage of dealing through an organized exchange is that a direct contractual relationship between a writer and holder of an option does not exist. Instead, each party deals directly with the clearing organization established by the exchange. Thus, in marketing through the CBOE, the writer of a put or call deals directly with the OCC. The writer is paid by the OCC for writing the option, and is obligated only to the OCC to perform in the event the option is exercised. Conversely, a purchaser of an option acquires the option from the OCC and looks to the OCC for performance if the option is exercised.

12.02[2][d] Exchange Mechanics

***6** A brief overview of the mechanical aspects of trading in options is described below.

12.02[2][d][i] Opening transactions.

The life of an exchange-traded option begins when the writer of the option, in what is referred to as an "opening sale transaction," places the option for bid on the exchange. The purchaser agrees to pay a premium in an "opening purchase transaction." The parties then inform the OCC of the transaction, and as a result, the OCC becomes a party to the contract. Thus, the OCC issues the option to the holder and in effect receives one from the writer. The premium paid by the holder is transferred to the writer through the clearing organization.

12.02[2][d][ii] Exercise and assignment.

If the option holder decides to exercise his option, the clearing organization is notified of this decision, typically through the holder's broker. The organization then selects at random an option writer to whom the exercise is assigned. In this event, the assigned writer is obligated to sell or purchase the stock in accordance with terms of the option. A holder relies on the clearing organization for performance and the writer is obligated to the clearing organization to perform. [24] In effect, the clearing organization guarantees clearance, settlement, and performance. [25] As a result, the rights and obligations of holders and writers in exchange-traded options cannot be assigned outside of the exchange without the OCC's consent.

12.02[2][d][iii] Closing transactions.

Organized exchanges have also established procedures for writers and holders to terminate their option positions prior to exercise or lapse. This is done by entering into a "closing transaction." A closing transaction is accomplished by writing or purchasing an option that is exactly opposite from the position held. Thus, the writer of an option can enter into a "closing purchase transaction" by purchasing an option on the same stock with the same expiration and strike price. Similarly, a holder of an option can enter into a "closing sale transaction" by selling or writing an option on the same stock with the same expiration and strike price. Closing transactions thus permit a writer and holder to terminate their interests in an option (and realize any profit or loss on the transaction) without exercising the option or waiting for it to lapse.

Example 12-7

Assume that in March, Individual *A* purchases for $400 an ABC/September/50 call. As of June, the value of the call has increased to $500. Individual *A* wishes to liquidate his position and lock-in the gain of $100. Accordingly, *A* instructs his broker to sell an offsetting call for $500. *A* receives $500, the two contracts offset each other, and A's rights and obligations are extinguished.

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Footnotes

7 See Holmes v. Comm'r, 37 TCM 1825 (1978).

7.1 See, e.g., Old Harbor Native Corp. v. Comm'r, 104 TC 191 (1995) . Accord FSA 199904033 (option present because taxpayer had unconditional power of acceptance for a specified or reasonable period of time without an obligation to pay the purchase price).

7.2 See Old Harbor Native Corp. v. Comm'r, 104 TC 191, 201 (1995) . See also Saviano v. Comm'r, 80 TC 955, 971 (1983), aff'd, 765 F2d 643 (7th Cir. 1985), discussed at ¶ 12.04[3][a].

7.3 Koch v. Comm'r, 67 TC 71 (1976).

7.4 Federal Home Loan Mortgage Corp. v. Comm'r, 125 TC 248 (2005).

8 Because the option is exercisable at any time prior to exercise, it is also an American-style option. See infra ¶ 12.02[1][f].

9 See infra ¶ 12.02[1][g].

10 Because the option is exercisable at any time prior to exercise, it is also an American-style option. See infra ¶ 12.02[1][f].

11 In effect, the economics of holding a put are opposite to those of holding a call.

12 IRC § 1234(c)(2). See Staff of the Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1984 (Joint Comm. Print 1984) (hereinafter 1984 Bluebook).

13 Options Clearing Corporation, Characteristics and Risks of Standardized Options 41 (Sept. 1987) (hereinafter Options Clearing Corporation).

14 Frances, "The Different Types of Options," in Handbook of Financial Markets, Securities, Options, Futures, 557-558 (F. Fabozzi & F. Zarb eds. 1981).

15 See generally McMillan, Options as a Strategic Investment ch. 25 (3d ed. 1993).

16 See supra ¶ 12.02[1][c].

17 Options Clearing Corporation at 8.

18 Id.

19 Id. at 9.

20 Id.

21 The Options Institute: The Educational Division of the Chicago Board Options Exchange, Options: Essential Concepts and Trading Strategies 13 (1990).

22 In common parlance, the term "stock option" generally refers to options on common or preferred stocks. However, financial professionals use the term to describe options on equity securities in general, which can include common stocks as well as limited partnership interests and American Depository Receipts (representing interests in foreign entities). See Options Clearing Corporation at 26.

23 The number of underlying shares may be adjusted to take into account certain events, such as stock splits and stock dividends.

24 Options Clearing Corporation at 70.

25 The obligations of writers to the OCC are guaranteed by a group of brokerage firms called "clearing members" that carry the accounts of writers or their brokers. To qualify as a clearing member, a firm must meet special OCC financial requirements. Clearing members must provide the OCC with margin or other collateral for the writers' positions that they carry and must also contribute to "clearing funds" that protect the OCC against a clearing member's failure. The clearing funds carry positions in options and back up the obligations of all clearing members in connection with options. Thus, the OCC's backup system is comprised of the financial strength of its clearing members, the collateral that they deposit, and the clearing funds. See id.

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CHECKPOINT

Ajay Gupta
Financial Products Taxation
Reading #10

Treatment of Options

Code: § 1234

Treatise: Keyes, Federal Taxation of Financial Instruments & Transactions, Chapter 12, Treatment of Options (Tax Consequences to Option Holders and Writers), ¶12.03 (Attached).

*Fed. Home Loan Mortg. Corp. v. Commi*ssioner, 125 T.C. 248 (2005) (Attached).

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Fed. Tax. Fin. Instruments & Transactions ¶ 12.03

***1 Federal Taxation of Financial Instruments & Transactions**

October 2020

Keyes

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Part III. Derivatives and Other Financial Instruments

Chapter 12. Treatment of Options

12.03 TAX CONSEQUENCES TO OPTION HOLDERS AND WRITERS

Prior to the Tax Reform Act of 1976, the rules of Section 1234 applied only to purchasers and holders of options. In 1976, Congress added rules to Section 1234 to deal with option grantors. Accordingly, the rules dealing with holders and grantors of options are now found in Sections 1234(a) and 1234(b), respectively. In 1984, Congress added Section 1234(c) to clarify the treatment of certain options that settle in cash. [26]

12.03[1] General Framework Under Section 1234

With regard to holders, Section 1234(a) generally provides for capital treatment upon the sale or exchange of an option if the underlying property is or would have been a capital asset in the hands of the holder. [27] A lapse of an option is generally treated as a sale or exchange of the option on the date of expiration. [28]

Prior to 1976, the tax treatment of grantors was governed by various judicial and administrative authorities. The premium received by the grantor of an option was not considered to be taxable upon receipt, because one could not determine whether the premium was a return of capital or gain until the option was allowed to expire. [29] In addition, the character of the gain or loss to the grantor upon expiration was ordinary, not capital, since no sale or exchange of an asset had occurred. [30] Congress found this ordinary treatment to be abusive in certain cases, and consequently added Section 1234(b) to the Code in 1976. [31]

Under Section 1234(b), a grantor of an option does not have taxable income until the option transaction is completed through lapse, exercise, sale, or other disposition. [32] That is, the transaction remains open until one of these events occurs. Any gain or loss on a closing transaction, or gain on the lapse of an option, is short-term capital gain or loss. [33] For this purpose, "closing transaction" is defined as any termination of the writer's obligation under an option other than through the exercise or lapse of the option. [34]

Section 1234 by its terms applies to options to buy or sell property. The term "property" is not specifically defined for purposes of option holders under Section 1234(a). For Section 1234(b) purposes, the term "property" means "stock," "securities," "commodities," and "commodity futures." [35] Thus, Section 1234(b) does not technically apply to a written option that does not

relate to this type of property (e.g., writing an option to buy or sell real property). As a result, a closing transaction or lapse may produce ordinary income or loss under common law principles in these instances. [36]

12.03[2] Interaction of Section 1234 With Other Code Provisions and Rules

***2** As mentioned at the outset, the rules of Section 1234 are relatively straightforward. The more difficult aspect is determining where Section 1234fits into the maze of provisions affecting financial transactions. For example, certain options are excluded from the purview of Section 1234 and are subject to tax under Section 1256. In addition, the rules of Section 1234may apply in conjunction with other rules, such as the foreign currency rules of Section 988, [37] the straddle rules of Section 1092 [38] and the conversion rules of Section 1258. [39]

12.03[2][a] Options That Constitute Section 1256 Contracts

Section 1234 generally does not apply to options that fall within the definition of "Section 1256 contract." [40] According to Section 1256(b), an option is a Section 1256 contract if the option is a "listed" option that also constitutes a "nonequity option" or "dealer equity option." While the definitions of these options and their tax treatment under Section 1256 are discussed in detail in the following chapter, it can be mentioned here briefly that dealer equity options that are entered into by the dealer for investment purposes may remain subject to Section 1234. Further, any equity option held by a non-dealer (e.g., an investor) and any non-listed nonequity option generally fall within Section 1234. [41] Moreover, Section 1234 can apply if an election is made to exclude a Section 1256contract from Section 1256 treatment. [42]

12.03[2][b] Options as a Hedging Transaction

Section 1234 does not apply to determine the character of gain or loss on an option that is (or is identified as being a part of) a hedging transaction. [43] The character of gain or loss on these options is determined under the rules provided in Regulation Section 1.1221-2, dealing with hedging transactions. [44]

12.03[2][c] Options Held in Inventory

Section 1234(a)(3)(A) provides that the sale or exchange treatment mandated by Section 1234(a) does not apply to the holder of an option to the extent that the option constitutes inventory or inventory-type property in the holder's hands. [45] Thus, a dealer in options—one who buys and sells options written by others—receives ordinary income treatment, not capital treatment. [46] As to the grantor of an option, Section 1234(b)(3) states that Section 1234(b) does not apply to any option granted in the ordinary course of a taxpayer's trade or business of granting options. [47] Conversely, the character rules of Section 1234(b)(1) would apply to (1) gain from any closing transaction or lapse of an option if the gain on the sale or exchange of the option would be considered capital gain by a dealer in securities under Section 1234(a), [48] and (2) loss from any closing transaction with respect to an option if loss on the sale or exchange of the option would not be considered ordinary loss by a dealer in securities under Section 1234(b). [49]

12.03[2][d] Compensatory Options

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***3** From the holders' perspective, Section 1234 does not apply to the extent that gain from an option is in the nature of compensation. [50] Similarly, with respect to grantors, Section 1234 does not apply to options to purchase stock or other property which are issued as compensation for services rendered. [51] However, once the compensation component of the options is closed and accounted for, Section 1234 should apply to determine tax treatment of the option (e.g., consequences of lapse, sale, or exercise).

12.03[2][e] Issuance of Warrants

Under Section 1032, the writer or corporate issuer of a warrant is not subject to tax upon the issue, repurchase, or lapse of its warrant. [52] Thus, if a corporation sells warrants to the public, the receipt of the premium is not taxable. Moreover, if the warrants expire without exercise, the premium remains nontaxable. [53] In effect, the premium represents tax-exempt capital.

In Technical Advice Memorandum 200622046, the taxpayer received a warrant to purchase stock in a telecommunications service provider. The warrant was provided in connection with a service agreement that allowed the taxpayer's customers to receive services under the telecommunication provider's reduced tariff. The parties agreed that the warrant was a noncompensatory warrant, and the Service determined that the warrant was includable in income at fair market value under the all events test upon the grant date. According to the Service, several characterizations of the transactions were possible. The taxpayer asserted that the transaction was an exchange of a zero-basis intangible asset (i.e., customer traffic) for the warrant. Other possible characterizations included the notion that the receipt of the warrant was a taxable incentive payment in some form. The Service concluded, however, that none of the possible characterizations would permit the taxpayer to exclude income from the grant of a warrant with a determined value. In the Service's view, the warrant could not be viewed, on the facts, as an additional sales discount.

12.03[2][f] Married Put Options

Section 1234 does not apply to the loss that arises from the failure to exercise a married put. A “married put” refers to an option to sell property at a fixed price that is (1) acquired on the same day as the underlying property, and (2) is identified as intended to be used in exercising the put option. If the put option lapses, the resulting loss is not recognized, but instead is added to the basis of the stock to which it is identified. [54]

12.03[3] Treatment of Option Holders

The tax consequences to holders as the result of certain option transactions are set forth below. Unless stated otherwise, it is assumed that Section 1234 applies and that the underlying property subject to the option is a capital asset in the hands of the holder. [55]

12.03[3][a] Payment of Premiums and Other Costs

***4** The premium paid by the holder in purchasing an option is a nondeductible capital expenditure. In addition, any transactional costs, such as fees or commissions paid, must also be capitalized and added to the basis of the option in the hands of the holder. These costs are taken into account upon a subsequent sale, exchange, lapse, or other termination of the option (e.g., a closing transaction). [56]

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Example 12-8

Investor *A* purchases an ABC/June/50 call on March 1 (an option to purchase 100 shares of *ABC* corporation stock for $50 per share expiring in June). Assume that *A* pays $300 to the option writer, and further that *A* pays a $25 commission to her broker. *A* cannot currently deduct the premium or the commission paid but must capitalize the costs instead. Accordingly, *A* 's basis in the option would be $325.

12.03[3][b] Sale or Other Disposition

Gain or loss is recognized by an option holder upon the sale, exchange, or other disposition of the option. The character of the gain or loss is determined by the character of the underlying property. Therefore, if the underlying property would be a capital asset in the hands of the holder,[57] then the gain or loss on the sale or disposition of the option is capital gain or loss. Such gain or loss is treated as short-term or long-term, depending on the holding period of the option by the holder.[58] Commissions and other expenses of sale reduce the amount realized on the sale of the option.[59] Losses would be subject to the limitations on losses under Sections 165(c) and 1211.[60]

Example 12-9

Assume the same facts as in Example 12-8. After the option was purchased, the price of the ABC stock increases and *A* sells the option for $55. Thus, assuming *A* pays a $25 commission on the sale, *A* has a gain of $150 ($500 sales price minus $25 (commission) minus $325 (basis)). Since the option was not held for the long-term holding period, the gain is short-term capital gain.

If a taxpayer is deemed to have dealer status with respect to the option, any gain or loss realized from the sale or exchange of an option to buy or sell property is generally considered ordinary income or loss.[61]

12.03[3][c] Expiration or Lapse

If the holder allows an option to expire or lapse without exercise, the option is deemed to be sold or exchanged on the date of expiration.[62] Accordingly, the holder may generally deduct the basis (i.e., the premium and any transaction costs paid upon purchase of the option) as a capital loss. The loss is treated as short-term or long-term depending on the holding period of the option.[63]

Example 12-10

Assume the same facts as in Example 12-8. However, assume that the ABC stock subsequently falls in price, so that the June call expires without exercise. In this case, *A* has a loss equal to her entire basis in the option, or $325. *A* would report the loss as a short-term capital loss.

12.03[3][d] Treatment Upon Exercise

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***5** When the holder exercises a call option, the cost of the call option (i.e., the premium and any transaction costs) is added to the holder's basis in the property acquired with the option. [64] The holding period of the acquired property begins on the day after the exercise. [65]

Example 12-11

Assume the same facts as in Example 12-8, except that instead of selling the option, *A* exercises the option. *A* pays the writer $5,000 for the stock pursuant to the terms of the option. *A* 's basis in the stock acquired is $5,325 ($5,000 (strike price paid) + $325 (basis in option)). The holding period for the stock begins on the day after it is acquired pursuant to the option exercise.

Conversely, when the holder of a put exercises the option, the cost of the put option reduces the amount realized upon sale of the underlying property. Assuming the property is a capital asset, any gain or loss on the property transferred in satisfaction of the put option is treated as short-term or long-term capital gain, depending on the holding period of the property in the hands of the holder. [66]

12.03[3][e] Closing Transactions

In the case of a closing transaction, gain or loss equal to the difference between the premium paid in the opening purchase transaction and the premium received in the closing sale transaction is recognized.

Example 12-12

Assume the same facts as in Example 12-8, except that *A* decides to close the option. Accordingly, *A* sells an option to buy ABC stock at $50 on the exchange. *A* pays a $25 commission and thus receives $475 net. *A* reports gain after commissions are considered of $150 ($475 (net amount realized) − $325 (basis in option)).

12.03[4] Treatment of Option Writers

The tax consequences to writers in option transactions is summarized below in the context of various option events. Unless stated otherwise, it is assumed that Section 1234 applies, that the option relates to property, and that the option is not granted in the course of the writer's trade or business of granting options.

12.04[4]:[a] Receipt of Premium

The premium received for writing an option is not included in the writer's income at the time of receipt. [67] This rule applies even if the premium is paid periodically over time. [68] Commissions and fees paid are deducted from the premium received [69] and thus only the net premium is deferred. The premium is taken into account when one of the events described below occurs.

12.03[4][b] Treatment Upon Lapse or Expiration

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A writer recognizes taxable gain once the obligation under an option is terminated due to the holder's failure to exercise the option. The amount of the gain is generally equal to the net premium received by the writer in the opening sale transaction. This gain is taxable as short-term capital gain. [70]

12.03[4][c] Treatment Upon Exercise

***6** When a call option is exercised by a holder, the writer is obligated to sell the underlying property to the holder. Accordingly, the net premium received by the writer in the opening sale transaction is added to the amount realized on the sale of the underlying property to the holder. [71] Any gain or loss is treated as short-term or long-term capital gain or loss depending on the writer's holding period of the underlying property. [72]

Example 12-13

Investor *A* writes an option to sell ABC stock at $50. A receives a $300 premium and pays $25 in commission on the sale. A thus receives a net amount of $275. Assume that after the option is written, the price of ABC stock increases and *A* is assigned the option exercise. Accordingly, *A* transfers 100 shares of ABC stock for delivery to the option holder. Assuming that A has stock commission costs of $75, her net amount realized will be $5,200 (net option proceeds of $275 ($300 − $25) plus net stock proceeds from assignment of $4,925 ($5,000 − $75)). *A* 's gain or loss on the resulting stock sale will depend on her basis in the underlying stock. Moreover, that gain or loss will be long-term or short-term, depending upon the holding period of the underlying stock.

Conversely, when a put option is exercised by a holder, the writer is obligated to purchase the underlying property from the holder. The premium received by the writer in the opening sale transaction decreases the writer's basis in the stock purchased. [73] In addition, the holding period during which the writer held the put option is not tacked to the holding period of the stock acquired by the writer upon the holder's exercise. [74] The holding period begins on the day after exercise. [75]

12.04[4][d] Closing Transactions

Upon completion of a closing transaction, the writer of the option recognizes short-term capital gain or loss. The amount of the gain or loss is the difference between the net premium that was received in the opening sale transaction and the premium paid in the closing purchasing transaction. [76]

Footnotes

26 DEFRA at § 105(a).

27 IRC § 1234(a)(1).

In Technical Advice Memorandum 200601029, the Service denied a loss deduction upon the expiration of a stock purchase contract because the taxpayer had acquired the underlying stock through other means. The Service determined that the taxpayer could not rely on Section 1234 to claim the deduction, because Section 1234 does not operate to treat a lapse as a loss transaction. Rather, Section 1234 establishes the character of the gains and losses arising from dealing

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in option transactions. The question of whether a loss arises as an initial matter is governed by Section 165 or by common law authorities that treat option transactions as open transactions. In this case, the Service believed that because a loss was not appropriate under these authorities, Section 1234 could not support the loss deduction.

28 IRC § 1234(a)(2).

29 Virginia Iron Coal & Coke Co. v. Commissioner, 37 BTA 195, aff'd., 99 F2d 919 (4th Cir. 1938), cert. denied, 307 US 630 (1939) ; Rev. Rul. 58-234, 1958-1 CB 279.

30 Rev. Rul. 57-40, 1957-1 CB 266.

31 Pub. L. No. 455, 94th Cong., 2d Sess., § 2136 (1976). An example of the abuse that caught Congress's attention is provided in the legislative history:

Assume that a taxpayer in the 50 percent tax bracket purchases 100 shares of IBM shares for $200 a share. He also writes a call on the stock having a strike price of $200 per share, for a premium of $2,500. If the value of the stock rises to $250 per share, and the taxpayer has held his stock for more than 6 months (at the time, the long-term holding period), he may sell the stock, realizing a long-term capital gain of $5,000 on which he owes $1,250 of tax (assuming a 50 percent capital gain deduction). He also enters into a closing transaction with respect to his call by purchasing a call on IBM at a strike price of $200 per share for a premium of $5,000 (i.e., $50 increase in price multiplied by 100 shares), which 4results in an ordinary loss of $2,500 (i.e., the difference between the $2,500 premium he received for the call he wrote and the $5,000 premium he paid for the call he purchased). The $2,500 ordinary loss could offset other ordinary income for a tax savings of $1,250. The net result is that the taxpayer pays no tax on an option transaction producing a net economic income of $2,500.

HR Rep. No. 1192, 94th Cong., 2d Sess. 2-3 (1976). See also Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, 674 (Joint Comm. Print 1976).

32 Rev. Rul. 78-182, 1978-1 CB 265.

33 IRC § 1234(b)(1). But see infra ¶ 12.03[1] for options not relating to "property" as defined in Section 1234(b).

In Technical Advice Memorandum 201142020, the taxpayer was a commodity producer that sought to hedge its downside price exposure to commodity prices by entering into prepaid forwards and purchased put options that would cover specified levels of commodity production over a designated period of years. The put options were "financed" by the sale of call options. The options were not identified as hedges for tax purposes. Commodity prices rebounded, and the puts expired worthless. After the purchased puts expired worthless, the taxpayer restructured the written call options for financial accounting purposes.

The Service addressed several issues and concluded, in part, that the taxpayer's written call options continued to be "options" after they were restructured, and were not converted into forward contracts because of the changes that were made to the option strike price formula, as the taxpayer had argued. Section 1234A presumably would have produced ordinary loss treatment for the taxpayer if forward contract characterization were successful. However, since the modified contracts were found to be options, losses from the closing of those transactions were capital losses covered by Section 1234(b).

34 IRC § 1234(b)(2)(A).

35 IRC § 1234(b)(2)(B).

36 Section 1234A provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property as defined in Section 1092(d)(1)which is (or on acquisition would be) a capital asset in the hands of the taxpayer is treated as gain or loss from the sale of a capital asset. Thus, if Section 1234(b) does not capture gain or loss on a closing transaction or lapse, Section 1234A likely will if the property constitutes actively traded personal property under Section 1092. See ¶ 17.02[1](discussion of actively traded property). Conversely, it would seem that pre-1976 law still applies in the absence of Section 1234(b) or Section 1234A.

Importantly, the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 105th Cong., 1st Sess. § 1003(a) (1997), extended the sale or exchange treatment of Section 1234A to the cancellation, lapse, expiration, or other termination of a right

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or obligation with respect to any property, provided the property is (or on acquisition would be) a capital asset in the hands of the taxpayer. Thus, the extension of Section 1234A sale or exchange treatment encompasses property that is not personal property that is actively traded on an established exchange. Accordingly, Section 1234A now applies to (1) interests in real property and (2) non–actively traded personal property. An example of the first type of property interest is an amount received to release a lease from a requirement that the premise be restored on termination of the lease. An example of the second type of property interest is the forfeiture of a downpayment under a contract to purchase stock. Staff of the Joint Comm. on Tax'n, General Explanation of Tax Legislation Enacted in 1997, 105th Cong., 1st Sess. 189. With the expansion of Section 1234A, any remaining vitality to the pre-1976 law as it pertains to the termination of an option appears to have been lost.

37 See Chapter 15.

38 See Chapter 17.

39 See Chapter 19.

40 These options are subject to Section 1256, which requires taxpayers to treat these options as if sold for their fair market value on the last day of the year. Any resulting gain or loss is generally characterized as 60 percent long-term and 40 percent short-term capital gain or loss. For a detailed discussion of Section 1256, see Chapter 13.

41 See Chapter 13.

42 IRC §§ 1234(c)(1), 1256(d). See also 1984 Bluebook at 315-316.

43 Reg. § 1.1234-4.

44 Id. See Chapter 18 for a discussion of hedging.

45 IRC § 1234(a)(3)(A) (referring to property described in Section 1222(1)).

46 Reg. § 1.1234-1(d). This applies to options written and sold by others and held in the dealer's inventory for sale. Rev. Rul. 58-234, 1958 CB 279. It does not apply to options that the dealer himself writes. These options are subject to Section 1234(b)(3).

47 IRC § 1234(b)(3).

48 Reg. § 1.1234-3(c)(1).

49 Reg. § 1.1234-3(c)(2).

50 Reg. § 1.1234-1(e)(1).

51 Reg. § 1.1234-3(d). In these circumstances, the rules provided in Sections 61, 83, and 421 apply. See TAM 200043013 (warrants issued to bank in connection with lending transaction were not issued for services; Section 83 did not apply and amounts paid by the borrower to the bank to redeem the warrants were not deductible under Section 83; warrants were subject to the investment unit rules of Section 1273(c)(2) and value of warrant on date of issuance created OID deductible over the life of the loan). Accord Centel Communications Co. v. Comm'r, 920 F2d 1335 (7th Cir. 1990) (receipt of warrants were not compensatory in nature; Section 83 did not apply).

52 Section 1032 was amended in 1984 to specifically apply to options acquired or lapsed after July 18, 1984. DEFRA at § 57(a). For the Service's position under prior law, see Rev. Rul. 72-198, 1972-1 CB 223.

53 IRC § 1032(a); Rev. Rul. 88-31, 1988-1 CB 302.

54 Reg. § 1.1234-1(c). See ¶ 16.03[2][d][ii] for further treatment of married puts.

55 As indicated above, this capital treatment does not apply in a number of cases. First, capital treatment does not apply to options held by a holder primarily for sale to customers in the ordinary course of his trade or business. IRC § 1234(a)(3)(A); Reg. § 1.1234-1(d). See supra ¶ 12.03[2] [c]. Second, capital treatment does not apply to losses attributable to the failure to exercise an option described in Section 1233(c) pertaining to short sales. IRC § 1234(a)(3)(C); Reg. § 1.1234-1(c). See supra ¶ 12.03 [2][f]. Third, capital treatment is not available for gains on the sale of options if the gain derived from the option, without regard to Section 1234, would result in ordinary income. IRC § 1234(a)(3)(B). Finally,

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Section 1234 does not apply to options that are compensatory in nature (e.g., employee stock options), options that are treated as Section 306 stock, or options that are taxable as a dividend. Reg. § 1.1234-1(e). See supra ¶ 12.03[2][d].

56 Rev. Rul. 78-182, 1978-1 CB 265, citing to Rev. Rul. 58-234, 1958-1 CB 279 (with respect to call options) and Rev. Rul. 71-521, 1971-2 CB 313 (with respect to put options). In an exchange setting, this transaction is referred to as an "opening purchase transaction."

57 IRC § 1234(a)(1); Reg. § 1.1234-1(a). The Section 1234 regulations acknowledge that gain or loss on the underlying property may be subject to the provisions of Section 1231. However, such characterization would not be applicable to options on stocks and securities. IRC § 1.1234-1(a)(2).

58 Reg. § 1.1234-1(a); Rev. Rul. 78-182, 1978-1 CB 265, citing to Section 1222. Assuming a long-term holding period of more than one year, any gain or loss with respect to exchange-traded options would generally be short-term, unless the option is a long-term option such as a LEAP. See supra ¶ 12.02[1][e].

59 Rev. Rul. 58-234, 1958-1 CB 279.

60 Reg. § 1.1234-1(f). Thus, Section 1234 does not convert an otherwise nondeductible loss into a deductible one.

61 Reg. § 1.1234-3(d). See supra ¶ 12.03[2][c].

62 IRC § 1234(a)(2); Reg. § 1.1234-1(b). In Field Service Advice Memorandum 199904033, the Service indicated that the termination of an option may constitute an expiration, and be treated as a sale or exchange, of the option if the termination as a factual matter leaves no possibility for subsequent exercise of the option.

63 Rev. Rul. 78-182, 1978-1 CB 265, citing to Sections 1234(a) and 1222. However, in Dunlap v. Comm'r, 670 F2d 785 (8th Cir. 1982), the taxpayer was denied a loss deduction upon the lapse of the first of ten annually exercisable options on one property. The court held that the ten successive options created a single ten-year option that could not lapse until the end of ten years.

64 Rev. Rul. 78-182, 1978-1 CB 265, citing to Rev. Rul. 58-234, 1958-1 CB 279. In Private Letter Ruling 199927022, the Service ruled that a lessor's receipt of a warrant to acquire stock in a lessee corporation was a closed transaction, rather than an open transaction, because the warrant could be valued at the time of warrant. Accordingly, the lessor did not recognize income when it exercised the warrant even though the then fair market value of the acquired stock exceeded the warrant's exercise price.

65 Rev. Rul. 88-31, 1988-1 CB 302; Rev. Rul. 70-598, 1970-2 CB 168. Compare the treatment of cash settled options infra ¶ 12.04[2] (i.e., exercise of such options is taxable event).

66 Rev. Rul. 78-182, 1978-1 CB 265, citing to Section 1222. However, the acquisition of put is treated as a short sale under Section 1233(b). Thus, unless the married put rule applies or the underlying stock satisfied the long-term holding period when the option was acquired, Section 1233(b) will operate to produce short-term capital gain on the sale of the underlying stock pursuant to the option. See ¶ 16.03[2][d].

67 Rev. Rul. 78-182, 1978-1 CB 265, citing to Rev. Rul. 58-234, 1958-1 CB 279 (with respect to call options) to Rev. Rul. 71-521, 1971-2 CB 313 (with respect to put options).

68 Koch v. Comm'r, 67 TC 71 (1976).

69 Rev. Rul. 58-234, 1958-1 CB 279.

70 IRC § 1234(b)(1). An issue may be raised as to whether an option has lapsed or merely been extended. In TAM 9129002, the taxpayer-grantor wrote a ten-year option to buy real property that provided for annual premiums. At the end of the ten-year period, the parties agreed to extend the option for an additional ten years. Under the extension, the exercise price and the next ten annual premiums were reduced. The Service held that the extension created a new option and that the original option lapsed at the end of the first ten years. Thus, the premiums for the first ten years were includible in the taxpayer's income in the year of lapse.

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Importantly, the original agreement in TAM 9129002 did not contain a provision for extension in the original option contract. Accordingly, the Service did not address whether an extension under a provision in the original option contract would have delayed the lapse until the expiration date as extended.

Similarly, in Dunlap v. Comm'r, 670 F2d 785 (8th Cir. 1982), the court held that the ten successive options created a single ten-year option that would not lapse until the end of ten years. Although the Court was addressing whether the taxpayer-holder was entitled to a loss deduction upon the lapse of the first of ten annually exercisable options, the case is applicable to the timing of income by the grantor of the option. In Field Service Advice Memorandum 199904033, the Service indicated that the termination of an option may constitute an expiration, and be treated as a sale or exchange, of the option if the termination as a factual matter leaves no possibility for subsequent exercise of the option.

71 Rev. Rul. 78-182, 1978-1 CB 265, citing to Rev. Rul. 58-234, 1958-1 CB 279.

72 Rev. Rul. 78-182, 1978-1 CB 265, citing to Section 1222.

73 Rev. Rul. 78-182, 1978-1 CB 265, citing to Rev. Rul. 58-234, 1958-1 CB 279.

74 Rev. Rul. 78-182, 1978-1 CB 265.

75 Rev. Rul. 88-31, 1988-1 CB 302; Rev. Rul. 70-598, 1970-2 CB 168.

76 Id.

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125 T.C. 248, Tax Ct. Rep. (CCH) 56,199, Tax Ct. Rep. Dec. (RIA) 125.12

125 T.C. 248
United States Tax Court.

FEDERAL HOME LOAN MORTGAGE CORPORATION, Petitioner
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Nos. 3941–99, 15626–99.
|
Nov. 21, 2005.

Synopsis

Background: Federal Home Loan Mortgage Corporation (FHLMC) petitioned for review of IRS's determination that 0.5% nonrefundable portion of commitment fees that FHLMC received for entering into prior approval purchase contracts with mortgage originators should have been reported in taxable year that FHLMC received payment.

Holdings: The Tax Court, Ruwe, J., held that:

[1] contracts satisfied formal requirements of option contracts;

[2] economic substance of contracts indicated that they were option contracts; and

[3] policy rationale for tax treatment of option as open transaction applied to prior approval purchase contracts.

Decision for FHLMC.

West Headnotes (5)

[1] Internal Revenue Option payments

Federal Home Loan Mortgage Corporation's (FHLMC) prior approval purchase contracts with mortgage originators were put options, and FHLMC properly reported nonrefundable portion of commitment fees as option premiums. Rev. Rul. 58–234, 1958–1 C.B. 279.

[2] Internal Revenue Option payments

Option payments are not includable in income to the optionor until the option either has lapsed or has been exercised.

[3] Internal Revenue Option payments

Federal Home Loan Mortgage Corporation's (FHLMC) prior approval purchase contracts with mortgage originators satisfied formal requirements of option contracts, for purposes of determining whether 0.5% nonrefundable portion of commitment fees that FHLMC received for such contracts should have been reported in taxable year that FHLMC received payment, or in year in which originator failed to exercise its right to sell mortgage; contracts provided for optional delivery of mortgages by originator, Sellers' & Servicers' Guide provided that delivery of mortgage by originator was "optional," contracts established formula to determine price that FHLMC and originator agreed to use, contracts established specific time for originator to exercise its right to sell mortgage, and nonrefundable portion of commitment fee constituted consideration to FHLMC for granting option. Rev. Rul. 58–234, 1958–1 C.B. 279.

[4] Internal Revenue Option payments

Economic substance of Federal Home Loan Mortgage Corporation's (FHLMC) prior approval purchase contracts with mortgage originators indicated that they were option contracts, for purposes of determining whether 0.5% nonrefundable portion of commitment fees that FHLMC received for such contracts should have been reported in taxable year that FHLMC received payment, or in year in which originator failed to exercise its right to sell mortgage;

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even though originators delivered mortgages to FHLMC in approximately 99% of prior approval purchase contracts, originators were apparently willing to pay premium for option because they were uncertain about when or whether they would in fact have mortgage to sell to FHLMC. Rev. Rul. 58–234, 1958–1 C.B. 279.

[5] **Internal Revenue** Option payments

Policy rationale for tax treatment of option as open transaction, i.e., that outcome of transaction is uncertain at time payments are made, applied to Federal Home Loan Mortgage Corporation's (FHLMC) prior approval purchase contracts with mortgage originators, for purposes of determining whether 0.5% nonrefundable portion of commitment fees that FHLMC received for such contracts should have been reported in taxable year that FHLMC received payment, or in year in which originator failed to exercise its right to sell mortgage; when originator delivered mortgage, FHLMC properly treated nonrefundable portion of commitment fee as reduction in consideration that it paid for mortgage, whereas in those instances when originator failed to deliver multifamily mortgage to FHLMC within delivery period, FHLMC realized income in year that originator allowed option to lapse. Rev. Rul. 58–234, 1958–1 C.B. 279.

1 Cases that cite this headnote

***248** P received commitment fees for entering into prior approval purchase contracts with mortgage originators. The contracts obligated P to purchase mortgages from originators during a specified period of time pursuant to a pricing formula but did not require the originators to sell mortgages to P. The commitment fees equaled 2.0 percent of the principal amount of the mortgages. The commitment fees consisted of a 0.5–percent nonrefundable portion and a 1.5–percent refundable portion. In the taxable years 1985 through 1990, P treated the 0.5–percent nonrefundable portion of the commitment fees as premiums received for writing put options. As a result, when an originator sold a mortgage to P, P treated the 0.5–percent portion of the fee as a reduction of its purchase price and reported this amount as income over the estimated life of the mortgage. If an originator failed to sell the mortgage to P, P reported the 0.5 percent of the fee in the year in which the originator failed to exercise its right to sell the mortgage. R determined that the nonrefundable commitment fees should have been reported in the taxable year that P received the payment.

Held: In substance and form, P's prior approval purchase contracts were put options, and P properly reported the nonrefundable portion of the commitment fees as option premiums.

Attorneys and Law Firms

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Gary D. Kallevang, for respondent.

OPINION

RUWE, J.

Respondent determined deficiencies in petitioner's Federal income taxes in docket No. 3941–99 as follows:

Year	Deficiency
1985	$36,623,695
1986	40,111,127

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***249** Petitioner claims overpayments of $9,604,085 for 1985 and $12,418,469 for 1986.

Respondent determined deficiencies in petitioner's Federal income taxes in docket No. 15626–99 as follows:

Year	Deficiency
1987	$26,200,358
1988	13,827,654
1989	6,225,404
1990	23,466,338

Petitioner claims overpayments of $57,775,538 for 1987, $28,434,990 for 1988, $32,577,346 for 1989, and $19,504,333 for 1990.

In this Opinion, we decide whether certain nonrefundable commitment fees that mortgage originators paid to petitioner to enter into Conventional Multifamily Prior Approval Purchase Contracts (prior approval purchase contracts) are to be recognized when those fees are paid or should be treated as premium for "put" options, which would defer recognition until after delivery or nondelivery of the underlying mortgages. [1] This issue is one of several involved in these cases. [2]

Background

The parties submitted this issue fully stipulated pursuant to Rule 122. [3] The stipulations of fact and the attached exhibits are incorporated herein by this reference. At the time it filed the petitions, petitioner maintained its principal office in McLean, Virginia. At all relevant times, petitioner was a corporation managed by a board of directors.

***250** Petitioner was chartered by Congress on July 24, 1970, by title III (Federal Home Loan Mortgage Corporation Act) of the Emergency Home Financing Act of 1970, Pub.L. 91–355, 84 Stat. 450. Petitioner was established to purchase residential mortgages and to develop and maintain a secondary market in conventional mortgages. A "conventional mortgage" is a mortgage that is not guaranteed or insured by a Federal agency. The "primary mortgage market" is composed of transactions between mortgage originators (lenders, such as savings and loan organizations) and homeowners or builders (borrowers). The "secondary market" generally consists of sales of mortgages by originators, and purchases and sales of mortgages and mortgage-related securities by institutional dealers and investors. Since its incorporation, petitioner has facilitated investment by the capital markets in single-family and multifamily residential mortgages. In the course of its business, petitioner acquires residential mortgages from loan originators. Petitioner's business is a high-volume, narrow-margin business.

A. *Multifamily Mortgage Program*

A multifamily mortgage loan is a loan secured on a property consisting of an apartment building with more than four residences. Petitioner offered originators two programs for selling multifamily mortgages: (1) The immediate delivery purchase program, and (2) the prior approval conventional multifamily mortgage purchase program (prior approval program).

1. *Immediate Delivery Purchase Program*

Petitioner designed the immediate delivery purchase program to accommodate the purchase of mortgages already closed and on an originator's books at the time an originator enters into a purchase contract with petitioner. Although this program is designed for portfolio mortgages, an originator may enter into an immediate delivery purchase contract with petitioner before actually closing on the mortgage. However, if for some reason the mortgage cannot be delivered, petitioner can impose sanctions on an originator.

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To participate in the immediate delivery purchase program, an originator telephones petitioner to make an offer ***251** for a purchase contract. When petitioner receives a telephone offer from an originator, that offer is "an irrevocable offer that the [originator] may not modify." Petitioner may accept an offer within 2 business days of receiving the telephone offer. When petitioner accepts an offer, it executes two copies of the purchase contract and mails the contract to an originator. Within 24 hours of receiving the purchase contract, an originator must execute the contract and mail one copy along with a $1,500 nonrefundable application/review fee or 0.1 percent of the purchase contract, whichever is greater, to petitioner's applicable regional office. If an originator failed to acknowledge and submit a copy of a purchase contract, petitioner may disqualify or suspend an originator as an eligible seller to petitioner. After completing a documentation review, underwriting, and property inspections, if any, petitioner's applicable regional office will contact an originator. The mortgages acceptable to petitioner will be identified and purchased.

An originator must deliver the mortgages to petitioner within the 30–calendar–day commitment period. In most cases, the penalty for nondelivery is disqualification or suspension of an originator from eligibility to sell mortgages to petitioner.[4]

Under the immediate delivery purchase program, petitioner established its required net yield when originators offered the contracts. The required net yield is the interest rate that petitioner will receive from the mortgage it purchases from an originator. Petitioner did not charge an upfront commitment fee in its immediate delivery purchase program.

2. *Prior Approval Program*

Alternatively, originators may sell multifamily mortgages to petitioner under the prior approval program, which began in 1976. Under this program, petitioner entered into contracts ***252** with originators to purchase a multifamily mortgage before the closing date of the mortgage. In general, each executed prior approval purchase contract pertained to a single mortgage, as opposed to a pool of mortgages. Petitioner's promotional pamphlets state that this program offered originators the "peace of mind" of knowing that petitioner would purchase the loan once it closed. The pamphlets also explain that once an originator entered into a prior approval purchase contract with petitioner, "delivery of the loan is still optional, so [the originators] don't have to worry if the deal hits a snag or falls through completely."

Under the prior approval program, originators were not obligated to deliver the multifamily mortgage to petitioner. Petitioner's Sellers' & Servicers' Guide is part of the contract between an originator and petitioner. Petitioner's Sellers' & Servicers' Guide states: "Delivery under this program is optional. However, unless the optional delivery contract is converted to a mandatory delivery contract within the 60–day optional delivery period, the mortgage may not be delivered and [petitioner] will retain the entire 2–percent commitment fee required pursuant to section 3004." The Sellers' & Servicers' Guide also provides:

> The *optional delivery* date stated in the purchase contract will be within 60 days from the date [petitioner] issues the purchase contract plus the 10–business–day period in which the [originator] may accept the purchase contract. During the 60–day period, if the [originator] intends to deliver the mortgage(s) to [petitioner], the [originator] must convert the *optional delivery purchase contract* to a 30–day mandatory delivery purchase contract.
> * * *

To receive a prior approval purchase contract from petitioner, an originator must submit a request for prior approval of a specific multifamily project. Along with the request, an originator paid a nonrefundable loan application fee of the greater of $1,500 or 0.10 percent of the original principal amount of the mortgage (but not in excess of $2,500). After completion of processing, including underwriting and property inspections, petitioner would determine if the mortgage is acceptable. *Id.* If acceptable, petitioner would execute a prior approval purchase contract (also called Form 6), which it mailed to an originator. An originator wishing to participate in the prior approval program ***253** would execute the Form 6, and mail or deliver it to petitioner no later than 10 business days from the date of petitioner's offer.

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Form 6 would set forth details of the specific mortgage that an originator could deliver.

Between 1985 and 1991, petitioner required an originator to submit a 2–percent commitment fee with the executed prior approval purchase contract. During the years at issue, the 2–percent commitment fee consisted of a 0.5–percent nonrefundable portion and a 1.5–percent portion that was refundable if an originator delivered the mortgage under the prior approval purchase contract. [5] Petitioner was entitled to keep the nonrefundable portion when it entered into the agreement. The 0.5–percent portion of the commitment fee received by petitioner was not held in trust or escrow and was subject to unfettered control by petitioner.

If an originator did not deliver the specific mortgage to petitioner, it forfeited the 1.5–percent refundable portion of the commitment fee. Forfeiture of the refundable portion of the fee in the event of nondelivery functioned as a delivery incentive consistent with petitioner's business preference to buy mortgages in the secondary market. [6]

Under the prior approval program, an originator had the right, but not the contractual obligation, to elect at any time during the ensuing 60 days (or in some cases 15 days), to enter into a mandatory commitment to deliver a conforming mortgage to petitioner. Under this program, petitioner committed to purchasing a mortgage when an originator delivered it to petitioner within the delivery period. [7]

Petitioner required originators to service the mortgages they sold to petitioner. Originators received compensation for performing this service (the compensation is known as the minimum servicing spread). For the years at issue, the minimum servicing fee (the originator's retained spread over the ***254** life of the mortgage) was 25 basis points (bps) [8] on mortgages less than $1 million, 12.5 bps on mortgages between $1 and $10 million, and was negotiable on mortgages more than $10 million.

To exercise its delivery right under a prior approval purchase contract, an originator was required to give notice of conversion to petitioner and enter into a 30–day "mandatory delivery contract" on Form 64A, Conventional Multifamily Immediate Delivery Purchase Contract and Prior Approval Conversion Amendment. An originator could elect to deliver the multifamily mortgage at petitioner's maximum required net yield or at an alternate required net yield. [9] Petitioner's required net yield was the rate at which originators could contract to deliver a mortgage under the immediate delivery purchase program. The maximum required net yield was the fixed rate, or locked-in interest rate, that petitioner and an originator had previously agreed upon in Form 6. [10] The alternate required net yield was the rate at which an originator could contract to deliver a mortgage to petitioner under the immediate delivery purchase program as quoted by petitioner on any day during the 60–day (or 15–day) optional delivery period; if the required net yield moved downward, an originator could select the lower required net yield. The purchase price and net yield to petitioner became fixed upon an originator's selection of either the maximum required net yield, or the alternate required net yield on any day during the 60–day (or 15–day) period that an originator elected an alternate required net yield. The purchase price either would reflect a discount from par (100 percent of unpaid principal balance (UPB)) or would be at par, depending on the relationship of the rate on the mortgages (coupon rate) actually tendered by an originator to the "minimum gross yield", which ***255** was the sum of the required net yield selected and the minimum servicing spread. [11]

For example, suppose an originator and petitioner entered into a prior approval purchase contract with respect to a mortgage in the maximum amount of $6 million. The originator paid the 2–percent commitment fee in the amount of $120,000. The mortgage was subject to a maximum mortgage interest rate of 12.595 percent and the maximum required net yield to petitioner was 12.470 percent. The difference, 0.125 percent or 12.5 bps, represents the minimum spread to be retained by an originator for servicing the mortgage, or $7,500/year. If an originator contemplated selling the subject mortgage to another buyer in lieu of petitioner, it would have to consider the effect of forfeiting the otherwise refundable portion of the commitment fee, or $90,000, in comparison to the spread it could obtain with another purchaser.

In the event that petitioner's required net yield on any day during the 60–day (or 15–day) period exceeded the "maximum required net yield", petitioner could be required on that day to contract to purchase conforming mortgages at the maximum required net yield stated on the Form 6, instead of at its current day required net yield. This arrangement

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effectively ensured that an originator could make a mortgage loan to a borrower at a particular rate, and would be protected against having to sell it to petitioner at a discount from par, or at an additional discount as a result of an increase in petitioner's required net yield during the 60–day (or 15–day) period. Because it could select the maximum required net yield if market rates increased, an originator was assured of dealing at a rate that was no higher than was specified in the prior approval purchase contract. Thus, an upward movement in interest rates normally would not prevent an originator from delivering a mortgage under the prior approval program. Alternatively, if interest rates went down, an originator would have the benefit (whether in the form of a greater spread or less of a discount from UPB) of selecting an alternate required net yield in lieu of the higher maximum ***256** required net yield as stated in the prior approval purchase contract. [12]

If an originator selected an alternate required net yield, it was required to give notice of this selection no later than the date of conversion to mandatory delivery. If an originator failed to give notice of conversion to a mandatory commitment within 5 business days of selecting an alternate required net yield, the prior approval purchase contract would be terminated, and petitioner would retain the entire 2–percent commitment fee.

Nondelivery generally occurred when the borrower repudiated or defaulted on its arrangement with the originator so that the originator did not have the mortgage to deliver. [13] Unlike originators who entered into an immediate delivery purchase program, when an originator participating in the prior approval program failed to deliver a mortgage, it was not disqualified or suspended as an eligible seller of mortgages to petitioner.

In computing its taxable income for the years 1985 through 1991, petitioner treated the 0.5–percent nonrefundable portion of the commitment fees as premium received for writing put options in favor of the various mortgage originators. Petitioner generally did not include in taxable income amounts received for the 0.5–percent nonrefundable portion of the commitment fee in the year of receipt. Petitioner deducted such nonrefundable amounts from the cost basis of mortgages purchased when originators delivered mortgages to petitioner. Petitioner amortized these amounts into income over multiyear periods of 7 or 8 years (i.e., the estimated life of the mortgages in petitioner's hands). [14] If an originator failed to elect mandatory delivery of the specified mortgages within the prescribed period, petitioner recognized the nonrefundable portion of the commitment fee in the current year ***257** if the last day of the 60–day (or 15–day) period was within the current year.

During the years 1985 through 1991, petitioner received the 0.5–percent nonrefundable portion of the commitment fees pursuant to the prior approval program in amounts totaling $9,506,398, $16,489,524, $9,408,907, $4,525,606, $4,892,445, $2,805,392, and $41,257, respectively. On its corporate returns for the years 1985 through 1993, petitioner included taxable income of $5,636,762, $16,627,101, $2,035,928, $2,601,628, $3,213,184, $3,563,858, $3,569,015, $3,569,015, and $3,569,015, respectively. The adjustments in dispute in the 1985–90 taxable years are the net differences between the amounts of nonrefundable commitment fees received and reported for tax purposes, as follows:

Nonrefundable Commitment Fees	Received	Reported	Amount in Dispute 1985–90
1985	$9,506,398	$5,636,762	$3,869,636
1986	16,489,524	16,627,101	(137,577)
1987	9,408,907	2,035,928	7,372,979
1988	4,525,606	2,601,628	1,923,978
1989	4,892,445	3,213,184	1,679,261
1990	2,805,392	3,563,858	(758,466)

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In computing its taxable income for the year 1985, petitioner overstated its income attributable to such receipts under its method of accounting in the amount of $883,638 as a result of a computational error.

During the years 1985 through 1988, and 1990, originators failed to deliver at least 67 mortgages specified in prior approval purchase contracts to petitioner.[15] See appendix, which lists these 67 contracts. As a result, the 1.5–percent refundable portion of the 2–percent commitment fee was forfeited to petitioner. During the relevant period, these 67 contracts represent approximately 1 percent (by value and number) of all the contracts that petitioner entered into in the prior approval program. Petitioner was not necessarily informed of the precise reason for the nondelivery; petitioner ***258** believes that the typical reason for nondelivery was failure of the underlying mortgage to have been consummated.

Discussion

[1] Petitioner argues that the 0.5–percent nonrefundable portions of the commitment fees that originators paid to enter into prior approval purchase contracts constitute "put" option[16] premiums, the tax treatment of which could not be determined until originators either exercised the options or allowed them to lapse. Respondent disagrees arguing that the 0.5–percent nonrefundable portions of the commitment fees are not option premium because the prior approval purchase contracts are not option contracts. Respondent argues that petitioner had a fixed right to the nonrefundable portion of the commitment fees when the prior approval purchase contracts were executed and that section 451 requires petitioner, as an accrual basis taxpayer, to recognize the nonrefundable commitment fees in the year of receipt because its right to retain the commitment fees was fixed and determined.

Section 451(a) generally provides that "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." Accrual method taxpayers normally recognize income when "all the events have occurred which fix the right to receive" income and the amount of income "can be determined with reasonable accuracy." Sec. 1.451–1(a), Income Tax Regs. However, as more fully explained, *infra,* payments of option premiums are not recognized when received, even when the recipient has a fixed right to retain the payments, because the character of those payments is uncertain until the option has been exercised or has lapsed. E.g., *Old Harbor Native Corp. v. Commissioner,* 104 T.C. 191, 200, 1995 WL 35310 (1995). Because of the unique facts in this case, we must examine the rules governing the tax treatment of option premiums and the policy underlying those rules to decide ***259** whether a prior approval purchase contract constitutes an option for Federal income tax purposes.

"An option has historically required the following two elements: (1) A continuing offer to do an act, or to forbear from doing an act, which does not ripen into a contract until accepted; and (2) an agreement to leave the offer open for a specified or reasonable period of time." *Id.* at 201 (citing *Saviano v. Commissioner,* 80 T.C. 955, 970, 1983 WL 14834 (1983), affd. 765 F.2d 643 (7th Cir.1985)). "The primary legal effect of an option is that it limits the promisor's power to revoke his or her offer. An option creates an unconditional power of acceptance in the offeree." *Id.* (citing 1 Restatement, Contracts 2d, sec. 25(d) (1981)). An option normally provides a person a right to sell or to purchase " 'at a fixed price within a limited period of time but imposes no obligation on the person to do so" '. See *Elrod v. Commissioner,* 87 T.C. 1046, 1067, 1986 WL 22052 (1986) (quoting *Koch v. Commissioner,* 67 T.C. 71, 82, 1976 WL 3657 (1976)). An agreement that purports to be an "option", but is contingent or otherwise conditional on some act of the offering party, is not an option. *Saviano v. Commissioner, supra* at 970.

An option contract grants the optionee the right to accept or reject an offer according to its terms within the time and manner specified in the option. *Estate of Franklin v. Commissioner,* 64 T.C. 752, 762, 1975 WL 3035 (1975), affd. on other grounds 544 F.2d 1045 (9th Cir.1976); 1 Williston on Contracts, sec. 5:16 (4th ed.2004). Options have been characterized as unilateral contracts because one party to the contract is obligated to perform, while the other

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party may decide whether or not to exercise his rights under the contract. *U .S. Freight Co. v. United States,* 190 Ct.Cl. 725, 422 F.2d 887, 894 (1970). Courts have found that the holder of an option must have a "truly alternative choice" to exercise the option or to allow it to lapse. *Id.* at 895; see also *Halle v. Commissioner,* 83 F.3d 649, 654 (4th Cir.1996), revg. and remanding *Kingstowne L.P. v. Commissioner,* T.C. Memo.1994–630; *Koch v. Commissioner, supra* at 82. Thus,

> the clear distinction between an option and a contract of sale is that an option gives a person a right to purchase [or sell] at a fixed price within a limited period of time but imposes no obligation on the person to do so, whereas a contract of sale contains mutual and reciprocal obligations, the seller being obligated to sell and the purchaser being obligated to buy. [*Koch v. Commissioner, supra* at 82.]

[2] ***260** Option payments are not includable in income to the optionor until the option either has lapsed or has been exercised. *Kitchin v. Commissioner,* 353 F.2d 13, 15 (4th Cir.1965), revg. T.C. Memo.1963–332; *Va. Iron Coal & Coke Co. v. Commissioner,* 99 F.2d 919 (4th Cir.1938), affg. 37 B.T.A. 195 (1938); *Elrod v. Commissioner, supra* at 1066–1067; *Koch v. Commissioner, supra* at 89. In Rev. Rul. 58–234, 1958–1 C.B. 279, 283–284, the Commissioner has reiterated these same principles:

> An optionor, by the mere granting of an option to sell ("put"), or buy ("call"), certain property, may not have parted with any physical or tangible assets; but, just as the optionee thereby acquires a right to sell, or buy, certain property at a fixed price during a specified future period or on or before a specified future date, so does the optionor become obligated to accept, or deliver, such property at that price, if the option is exercised. Since the optionor assumes such obligation, which may be burdensome and is continuing until the option is terminated, without exercise, or otherwise, there is no closed transaction nor ascertainable income or gain realized by an optionor upon mere receipt of a premium for granting such an option. The open, rather than closed, status of an unexercised and otherwise unterminated option to buy (in effect a "call") was recognized, for Federal income tax purposes, in *A.E. Hollingsworth v. Commissioner,* 27 B.T.A. 621, * * * (1933). It is manifest, from the nature and consequences of "put" or "call" option premiums and obligations, that there is no Federal income tax incidence on account of either the receipt or the payment of such option premiums, i.e., from the standpoint of either the optionor or the optionee, unless and until the options have been terminated, by failure to exercise, or otherwise, with resultant gain or loss. The optionor, seeking to minimize or conclude the eventual burden of his option obligation, might pay the optionee, as consideration for cancellation of the option, an amount equal to or greater than the premium. Hence, no income, gain, profits, or earnings are derived from the receipt of either a "put" or "call" option premium unless and until the option expires without being exercised, or is terminated upon payment by the optionor of an amount less than the premium. Therefore, it is considered that the principle of the decision in *North American Oil Consolidated v. Burnet,* 286 U.S. 417 * * * (1932), which involved the receipt of

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"earnings," is not applicable to receipts of premiums on outstanding options.

Rev. Rul. 58–234, *supra* at 284, 285, summarizes the tax treatment of put option premiums as follows:

> [T]he amount (premium) received by the writer (issuer or optionor) of a "put" or "call" option which is not exercised constitutes ordinary income, for Federal income tax purposes, under ***261** section 61 of the Internal Revenue Code of 1954, to be included in his gross income only for the taxable year in which the failure to exercise the option becomes final.

> [W]here a "put" option is exercised, the amount (premium) received by the writer (issuer or optionor) for granting it constitutes an offset against the option price, which he paid upon its exercise, in determining his (net) cost basis of the securities that he purchased pursuant thereto, for subsequent gain or loss purposes. * * *

See also Rev. Rul. 78–182, 1978–1 C.B. 265.

A contract is an option contract when it provides (A) the option to buy or sell, (B) certain property, (C) at a stipulated price, (D) on or before a specific future date or within a specified time period, (E) for consideration. *W. Union Tel. Co. v. Brown,* 253 U.S. 101, 110, 40 S.Ct. 460, 64 L.Ed. 803 (1920); *Halle v. Commissioner, supra* at 654; *Old Harbor Native Corp. v. Commissioner,* 104 T.C. at 201; *Estate of Franklin v. Commissioner, supra* at 762–763; Rev. Rul. 58–234, *supra.* To determine whether a contract constitutes an option, courts look at the contractual language and the economic substance of the agreement. *Halle v. Commissioner, supra.*

Petitioner's prior approval purchase contracts exhibit the following characteristics of an option for tax purposes: (1) The prior approval purchase contracts satisfy the formal requirements of option contracts; (2) the economic substance of the prior approval purchase contracts indicates that the contracts are an option; and (3) the rationale for granting open transaction treatment to option premium applies to petitioner's transactions.

1. *Formal Requirements of the Option*

[3] Petitioner's prior approval purchase contracts provide for the optional delivery of mortgages by an originator. The Sellers' and Servicers' Guide states: "Delivery under this program is *optional* . However, unless the *optional delivery* contract is converted to a mandatory delivery contract within the 60–day *optional delivery period,* the mortgage may not be delivered". (Emphasis added.) The contractual terms specifically provide that an originator has the right, but not an obligation, to sell the mortgage to petitioner. The prior approval purchase contract specified the mortgage that petitioner was obligated to purchase if an originator exercised its option. To participate ***262** in the prior approval program, an originator would execute and deliver to petitioner a Form 6, which set forth the details of a specific mortgage to be delivered.

Despite the language of the prior approval purchase contracts, respondent argues that the form of the contracts does not create an option. In support of its argument, respondent quotes the Sellers' & Servicers' Guide, which states: " 'Under this program, [petitioner] will *contract* with the [originator] before the closing date of the mortgage *to purchase* a multifamily mortgage on a specific existing project." ' Respondent argues that the terms contain an explicit offer to purchase by petitioner and an explicit acceptance by an originator.

We agree that petitioner has made an explicit offer to purchase an originator's mortgage; this is consistent with an option contract. In fact, an essential characteristic of an option contract is that one party is obligated to perform, while the other party may decide whether or not to exercise his rights under the contract. *U.S. Freight Co. v. United States,* 422 F.2d 887, 190 Ct.Cl. 725 (1970). Respondent's position ignores both the reality and the language in the Sellers' & Servicers' Guide that delivery of the mortgage by an originator is "optional".

Respondent argues that the prior approval purchase contracts are not options because these contracts lack a fixed purchase price that petitioner will pay in the event an originator delivered a mortgage. Respondent contends that the price

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was not fixed because an originator could deliver a mortgage at either the maximum required net yield or the alternate required net yield, which was not fixed until an originator converted a prior approval purchase contract into a mandatory delivery contract.

The prior approval purchase contracts establish a formula to determine the price, which petitioner and an originator agreed to use. Form 6 identified the amount of the mortgage that petitioner was obligated to purchase. The maximum required net yield provides the minimum price that petitioner would pay to an originator to purchase the mortgage. While the alternate required net yield allowed an originator to potentially receive a more favorable purchase price, we do not think that this feature of the contract changes the fact that the parties to the prior approval purchase contracts ***263** agreed to a formula that determined the stipulated price. See *Estate of Franklin v. Commissioner,* 64 T.C. at 763–764.

In an option contract, the seller agrees to hold an offer open for a specified period of time. *Old Harbor Native Corp. v. Commissioner, supra* at 201. It is clear that the prior approval purchase contracts establish a specific time for an originator to exercise its right to sell the mortgage to petitioner.

Petitioner granted an option for consideration. The Sellers' and Servicers' Guide states:

> A commitment fee of 2 percent of the amount of the purchase contract must be submitted by the [originator] with the executed purchase contract. Three-fourths of the commitment fee is refundable on the Freddie Mac funding date, when the mortgage, meeting all of the terms of the purchase contract and section 3803, is delivered to the applicable Freddie Mac regional office on or before the delivery date stated in the purchase contract.

When petitioner and an originator entered into a prior approval purchase contract, petitioner was entitled to retain the 0.5–percent nonrefundable portion of the commitment fee. This nonrefundable portion of the commitment fee constitutes consideration to petitioner for granting an option.

2. *Economic Substance of the Option*

[4] An essential part of any option is that its potential value to the optionee and its potential future detriment to the optionor depends on the uncertainty of future events. An optionee is willing to pay for potential future value, and the optionor is willing to accept a potential future detriment for a price. For example, in a typical put option, the optionee is willing to pay a premium to the optionor for the right to sell a security to the optionor at an agreed price sometime in the future. If the market value of the security falls below the exercise price, the optionee can sell the security to the optionor at a price greater than its value on the exercise date. That potential opportunity is what the optionee paid for. Likewise, the premium received by the optionor is compensation for accepting the potential risk of having to purchase at an unfavorable price. If the market value of the security rises above the exercise price, the option will not be ***264** exercised, and the optionor keeps the option premium for having accepted the risk associated with uncertainty.

The prior approval program involves an option to sell exercisable by an originator. An originator (optionee) can choose to enforce its rights to sell a mortgage to petitioner (optionor) at an agreed pricing formula but is under no legal obligation to do so. During the period when it can exercise its option to sell, the originator can choose between the agreed maximum yield for petitioner or, if interest rates fall, a lesser yield for petitioner. If interest rates rise above the agreed maximum yield, petitioner is required to purchase the mortgage on terms less favorable than they would have been at current rates.

The option of whether to sell the mortgage also protects an originator from the risk it might not close the subject mortgage, making the sale to petitioner impossible. Without the option, the originator's failure to deliver could result in serious sanctions including the originator's disqualification from further dealings with petitioner. An originator could avoid the commitment fee altogether by entering into an immediate delivery purchase contract; however, a failure to deliver the mortgage to petitioner under an immediate delivery purchase contract can result in sanctions including disqualification of an originator from future mortgage sales

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to petitioner. In most cases, the penalty for nondelivery is disqualification of an originator from eligibility to sell mortgages to petitioner. Given petitioner's prominent position in the secondary mortgage market, disqualification of an originator would seem to be of great importance to an originator and would explain why an originator is willing to pay the nonrefundable commitment fee in return for retaining the option to deliver the mortgage. The uncertainty of an originator's ability to deliver a mortgage that has not closed and the potential detriment to be suffered in that event, constitutes a future contingency that the optionee is willing to pay to protect itself against. This contingency, while apparently unlikely to occur, is obviously of sufficient concern to originators to justify selection of the prior approval purchase contract and payment of the nonrefundable portion of the commitment fee, rather than entering into an immediate delivery purchase contract and risk default and the related sanctions. Petitioner, on the other hand, is willing to make delivery ***265** optional, and thereby give up the rights and remedies it would have had under an immediate delivery contract, in return for the nonrefundable portion of the commitment fee.

Respondent argues that the possible forfeiture of the 1.5–percent refundable portion of the commitment fee makes it virtually certain that the mortgage sale will be consummated, negating any real option for an originator. Petitioner acknowledges that potential loss of the refundable portion of the commitment fee was intended to encourage an originator to sell the mortgage if there was a mortgage to sell. Indeed, an originator's agreement to forfeit the nonrefundable portion indicates its intent to follow through with the sale if possible. But the possible inability to deliver and related sanctions were apparently of sufficient concern to originators to justify payment of the 0.5–percent nonrefundable portion in order to make delivery optional. If such risk were not significant, originators could simply have entered into mandatory delivery contracts and avoided the nonrefundable fee.

Respondent cites *Halle v. Commissioner,* 83 F.3d 649 (4th Cir.1996), as authority for his argument that there was no option. In *Halle,* a corporation owned land, which the taxpayer wanted to purchase. The taxpayer formed a limited partnership to purchase all the stock of the corporation. The limited partnership and the corporation entered into a stock purchase agreement, which stated that " 'Seller hereby agrees to sell to Buyer, and Buyer agrees to purchase from Seller" ' the stock of the corporation for $29 million. The agreement required the limited partnership to pay a $3 million deposit and the balance at settlement. The agreement permitted the limited partnership to defer the settlement date by paying monthly installments of $225,000. If the limited partnership defaulted, the contract provided that it would forfeit the downpayment and monthly installments already paid. The limited partnership paid the seller $900,000 to defer settlement and deducted those payments as settlement interest on its income tax returns. The Commissioner disallowed the claimed interest deduction, arguing that the agreement was an option.

The Court of Appeals for the Fourth Circuit examined the language of the stock purchase agreement and the economic substance of the transaction to determine whether the contract ***266** was an option. The Court found that under the terms of the agreement, the seller had an unconditional obligation to sell the stock, the limited partnership had an unconditional obligation to purchase the stock, and the agreement did not expressly provide the limited partnership with the option to withdraw from the transaction. The court also found that the economic substance of the stock purchase agreement created indebtedness. To find that the contract created indebtedness, the court relied on "(1) the amount of the contractually specified liquidated damages, (2) the extent to which [the limited partnership] assumed real economic burdens of ownership before settlement, (3) [the limited partnership's] peripheral activities before settlement, and (4) the absence of apparent motives for creating an option contract." *Id.* at 655.

Unlike *Halle v. Commissioner, supra,* we find that the terms and the economic realities of the prior approval purchase contracts indicate that these contracts were options. The Sellers' & Servicers' Guide indicates that the prior approval purchase contract offers an alternative to the immediate delivery purchase program when an originator and the borrower have not closed on a mortgage. By entering into an immediate delivery purchase contract, an originator could receive a commitment from petitioner without paying the 0.5–percent nonrefundable fee. However, originators who participated in the prior approval program chose to pay the commitment fee to protect themselves from fluctuations in interest rates during the period when the option was open and the uncertainty associated with the possibility that the

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mortgages might not close within the delivery period. Had originators been absolutely certain that they could deliver the mortgages, they could have entered into an immediate delivery purchase contract and avoided any commitment fee. The prior approval purchase contracts provided an originator with protection in the event it could not deliver a mortgage to petitioner. Thus, despite the fact that originators delivered mortgages to petitioner in approximately 99 percent of the prior approval purchase contracts, originators were apparently willing to pay a premium for the option because they were uncertain about when or whether they would in fact have a mortgage to sell to petitioner.

***267** 3. *Rationale for Option Treatment*

[5] The policy rationale for the tax treatment of an option as an open transaction is that the outcome of the transaction is uncertain at the time the payments are made. That uncertainty prevents the proper characterization of the premium at the time it is paid. See *Dill Co. v. Commissioner,* 33 T.C. 196, 200, 1959 WL 1208 (1959), affd. 294 F.2d 291 (3d Cir.1961). "Since the optionor assumes such obligation, which may be burdensome and is continuing until the option is terminated, without exercise, or otherwise, there is no closed transaction nor ascertainable income or gain realized by an optionor upon mere receipt of a premium for granting such an option." Rev. Rul. 58–234, 1958–1 C.B. at 283.

Respondent argues that open transaction treatment is inappropriate because petitioner had a fixed right to the nonrefundable portion of the commitment fee at the time the prior approval purchase contracts were executed. However, the fixed right to a payment does not determine the tax treatment of an option premium. In *Va. Iron Coal & Coke Co. v. Commissioner,* 37 B.T.A. 195 (1938), affd. 99 F.2d 919 (4th Cir.1938), the taxpayer received payments for an option and had a fixed right to retain them. The Court explained that these payments were entitled to open transaction treatment, despite the taxpayer's right to retain the payments, because the taxpayer did not know whether the funds would represent income or a return of capital when they were received.

The uncertainty associated with the 0.5–percent nonrefundable portion of the commitment fee is similar to the uncertainty described by the Board of Tax Appeals in *Va. Iron Coal & Coke Co. v. Commissioner, supra.* In that case (involving a call option), the Court stated:

> Had the option been exercised, they [the premium] would have represented a return of capital, that is, a recovery of a part of the basis for gain or loss which the property had in the hands of the seller. In that event they would not have been income and their return as income when received would have been improper. * * * But in case of termination of the option and abandonment by the Texas Co. of its right to have the payments applied as a part of the purchase price, it would be apparent for the first time that the payments represented clear gain to the petitioner. In that case, since no property would be sold, there would be no reason to reduce the basis of that retained.

Id. at 198. ***268** In the instant case, when an originator delivered a mortgage, petitioner properly treated the nonrefundable portion of the commitment fee as a reduction in the consideration that it paid for the mortgage. See Rev. Rul. 78–182, 1978–1 C.B. 265, 266; Rev. Rul. 58–234, 1958–1 C.B. at 285 ("[W]here a 'put' option is exercised, the amount (premium) received by the writer (issuer or optionor) for granting it constitutes an offset against the option price, which he paid upon its exercise, in determining his (net) cost basis of the securities that he purchased pursuant thereto, for subsequent gain or loss purposes."). In those instances when an originator failed to deliver a multifamily mortgage to petitioner within the delivery period, petitioner realized income in the year that an originator allowed the option to lapse. See Rev. Rul. 58–234, *supra.*

Finally, respondent relies on *Chesapeake Fin. Corp. v. Commissioner,* 78 T.C. 869, 1982 WL 11098 (1982), to support his argument against treating the nonrefundable portion of the commitment fee as option premium. In

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Chesapeake Fin. Corp., the taxpayer made construction and permanent loans available to developers and received commitment fees. Typically, a borrower would apply for a loan for a proposed project, and the taxpayer would determine whether the project was economically feasible. If the taxpayer decided the project was feasible, it would obtain the borrower's authorization to place a loan with an institutional investor. If the institutional investor approved the loan, it issued a commitment to the taxpayer; upon acceptance, the commitment constituted a contract between the institutional investor and the taxpayer. The commitment specified the terms of the proposed loan and generally required the taxpayer to pay a nonrefundable commitment fee. Most commitments also required the taxpayer to pay an additional "deposit fee" in the event the loan failed to close. The "deposit fee" usually equaled 1 percent of the proposed loan. When the taxpayer received the commitment from the institutional investor, the taxpayer issued its own commitment to the borrower, which incorporated the terms and conditions of the institutional investor's commitment. The borrower was required to pay a commitment fee and an additional fee equal to the nonrefundable fee that the taxpayer paid to the institutional investor. The taxpayer had a fixed right to the commitment fee when the borrower ***269** accepted its commitment; however, the taxpayer reported the fees in income when the loans were permanently funded. The taxpayer argued that under the "all events" test, it had not earned the fees until the loans were actually funded.

The Court found that the taxpayer's "commitment fees were received as a payment for specific services rendered to the borrower in arranging for a favorable loan package for the borrower with an institutional investor." *Id.* at 878. The Court explained that the commitment fees compensated the taxpayer for "evaluating the economic potential of the proposed project, finding a willing investor to provide financing and then negotiating two separate commitments, one from the institutional investor and one that it issues to the borrower." *Id.* The Court held that the commitment fees were taxable in the year of receipt. [17]

The commitment fees in *Chesapeake Fin. Corp.* are distinguishable from the nonrefundable portion of the commitment fees received by petitioner for granting options. Whereas the taxpayer in *Chesapeake Fin. Corp.* acted as a loan originator for the borrower, petitioner agrees to purchase a mortgage from an originator. [18] *Chesapeake Fin. Corp.* involved a factually different type of transaction, and does not govern the tax treatment of petitioner's commitment fees. Indeed, in *Chesapeake Fin. Corp.,* there was apparently no argument and certainly no consideration or discussion by the Court about whether the fees might constitute option premiums. Instead, the taxpayer in *Chesapeake Fin. Corp.* argued that the "all events" test was satisfied when the loans were actually funded, not when it received the fees.

Conclusion

Because the terms and the economic substance of the prior approval purchase contracts indicate that petitioner and originators entered into option contracts, we hold that petitioner ***270** properly treated the 0.5–percent nonrefundable portion of the commitment fees as option premiums.

To reflect the foregoing,

An appropriate order will be issued.

Appendix

Mortgages Not Delivered To Petitioner Under The Prior Approval Program

During the taxable years 1985 through 1988, and 1990, the 67 mortgages, which the originators failed to deliver to petitioner, are as follows:

	Contract No.	Contract Amount	Expiration of 60–day (or 15–day) Period	0.5 Percent Nonrefundable Fee
1	8504030076	$1,000,000	5/17/85	$5,000
2	8501170017	153,000	6/7/85	765

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3	8510110117	430,000	11/10/85	2,150
4	8505100095	100,000	11/15/85	500
5	8511050016	560,000	12/5/85	2,800
6	8511210097	4,200,000	12/21/85	21,000
7	8605200051	2,939,000	6/2/86	14,695
8	8602070074	269,000	8/11/86	1,345
9	8607310296	1,365,000	8/30/86	6,825
10	8512120155	600,000	9/9/86	3,000
11	8606130126	539,000	9/10/86	2,695
12	8607170569	1,145,000	9/10/86	5,725
13	8602260159	100,000	9/17/86	500
14	8609220258	2,450,000	9/30/86	12,250
15	8609090420	194,000	10/9/86	970
16	8609100388	2,365,000	10/10/86	11,825
17	8609150342	4,020,000	10/15/86	20,100
18	8607110490	1,145,000	10/23/86	5,725
19	8609290083	504,000	10/29/86	2,520
20	8608060428	1,312,000	11/3/86	6,560
21	8610270173	396,000	11/4/86	1,980
22	8610300720	297,000	11/7/86	1,485
23	8610300728	250,000	11/7/86	1,250
24	8603260291	1,635,000	11/12/86	8,175
25	8610140245	750,000	11/13/86	3,750
26	8605160050	250,000	11/14/86	1,250
27	8607140072	379,000	11/17/86	1,895
28	8610210279	738,000	11/20/86	3,690
29	8611200558	350,000	11/24/86	1,750

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30	8610200110	410,000	11/25/86	2,050
31	8610310637	354,000	11/30/86	1,770
32	8611040013	605,000	12/4/86	3,025
33	8612150095	268,000	12/17/86	1,340
34	8611210206	300,000	12/21/86	1,500
35	8612240362	1,565,000	2/4/87	7,825
36	8704300034	537,000	7/14/87	2,685
37	8708100024	355,000	10/9/87	1,775
38	8708120349	1,600,000	10/11/87	8,000
39	8708120350	850,000	10/11/87	4,250
40	8708120351	255,000	10/11/87	1,275
41	8708200206	1,400,000	10/19/87	7,000
42	8708200328	515,000	10/19/87	2,575
43	8709255114	1,080,000	10/25/87	5,400
44	8712075071	525,000	1/6/88	2,625
45	8801225093	2,602,000	2/21/88	13,010
46	8802085188	700,000	3/9/88	3,500
47	8803245036	450,000	4/23/88	2,250
48	8805105385	1,712,000	6/9/88	8,560
49	8808055045	2,900,000	9/4/88	14,500
50	8808265106	2,000,000	9/25/88	10,000
51	8809305154	3,400,000	10/30/88	17,000
52	8810045195	800,000	11/3/88	4,000
53	8810175155	585,000	11/16/88	2,925
54	8811215091	700,000	11/28/88	3,500
55	8811085234	3,600,000	12/8/88	18,000
56	8811095145	750,000	12/9/88	3,750
57	8912125085	4,240,000	1/11/90	21,200

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58	8912115094	985,000	1/26/90	4,925
59	9001105083	970,000	2/9/90	4,850
60	9001255072	835,000	2/24/90	4,175
61	9002055068	2,335,000	3/7/90	11,775
62	9001195042	700,000	4/10/90	3,500
63	9002205045	130,000	5/22/90	650
64	9001175071	5,490,000	6/29/90	27,450
65	9007115075	100,000	8/10/90	500
66	9002215058	256,000	10/1/90	1,280
67	9008135001	667,700	12/31/90	3,335
Total:		$77,961,700		$389,905

All Citations

125 T.C. No. 12, 125 T.C. 248, Tax Ct. Rep. (CCH) 56,199,
Tax Ct. Rep. Dec. (RIA) 125.12

Footnotes

1 The adjustments proposed in the notices of deficiency for 1985 through 1990 pertaining to the commitment fee issue included a small amount of commitment fees related to single-family optional delivery mixed in with the prior approval program. The parties have since resolved the commitment fee issue as to the single-family program.

2 See *Fed. Home Loan Mortgage Corp. v. Commissioner,* 121 T.C. 129, 121 T.C. 254, 121 T.C. 279, (2003), T.C. Memo.2003–298.

3 All Rule references are to the Tax Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code in effect for the taxable years in issue.

4 Petitioner's Sellers' & Servicers' Guide, which is part of the contract, states that petitioner “may disqualify or suspend a * * * [an originator] for * * * [an originator's] failure to deliver any documents under a * * * mandatory delivery purchase program, as required by section 0601”. Sec. 0601 of the Sellers' and Servicers' Guide states that “Delivery under the * * * immediate delivery purchase programs is mandatory. * * * Delivery is not mandatory under the home mortgage optional delivery purchase programs.” The guide also provides that petitioner may disqualify or suspend an originator for “failure to observe or comply with any term or provision of the purchase document”. In addition to disqualification and suspension, petitioner “reserves the right to take whatever other action it deems appropriate to protect its interests and enforce its rights”.

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5 In 1982, petitioner charged a commitment fee equal to 2 percent of the commitment amount (the principal amount of the mortgage to be delivered), which was fully refunded to a mortgage originator if the mortgage was delivered. In September 1983, the commitment fee was changed so that the amount charged to a mortgage originator was still 2 percent, with 1 percent being nonrefundable and 1 percent refundable when the mortgage loan was delivered. The commitment fee structure was changed again for the years in issue.

6 For Federal income tax purposes, the 1.5–percent refundable portion of the commitment fee was treated by petitioner as a payable upon its receipt and was taken into income only if the underlying mortgages were not delivered to petitioner. Petitioner's tax accounting for the 1.5–percent refundable portion of the fee is not at issue.

7 The Sellers' & Servicers' Guide does not use the term “put options” or “put option” to describe these commitment arrangements.

8 A basis point (bp) is 1/100th of a percent.

9 Effective July 1986, upon electing to effectuate delivery with a mandatory delivery contract with an alternative required net yield, an originator could request an increase in the maximum amount of the mortgage to be delivered. The amount of any increase was at the sole discretion of petitioner. Upon the request for an increase, an originator was required to remit $1,000 plus 2 percent of the increased mortgage amount within 24 hours. Of this 2 percent, 0.5 percent was nonrefundable and, if approved, petitioner was entitled to retain the fee. Upon purchase of the mortgage, petitioner refunded 1.5 percent of the total mortgage amount as increased.

10 The maximum required net yield is the maximum interest rate that petitioner may receive from the mortgage delivered by an originator.

11 When an originator serviced a mortgage for petitioner, it received the amount of interest on the mortgage in excess of the required net yield. The minimum servicing spread is the difference between the maximum mortgage interest rate and the maximum required net yield.

12 If petitioner's required net yield on the day of delivery election was lower than the maximum required net yield, an originator holding a higher than current market-rate mortgage would normally obtain a spread greater than the minimum servicing spread specified in sec. 2603 of petitioner's Sellers' and Servicers' Guide.

13 An originator finding a more attractive opportunity for disposing of a mortgage had to consider the forfeiture of the 1.5–percent refundable portion of the commitment fee.

14 When a mortgage was delivered in the same year that petitioner received the commitment fee, petitioner recognized the nonrefundable portion of the commitment fee in the year of receipt, to the extent of amortization for that year.

15 Petitioner was unable to locate records of the prior approval purchase contracts executed in 1989 that would identify the mortgages from that year, if any, where the specified mortgages were undelivered.

16 A “put” option gives the option holder the right, but not the obligation, to sell something at an agreed upon price or pricing formula for a limited period of time.

17 In addition to the fees in issue, petitioner also received a nonrefundable application/review fee of the greater of $1,500 or 0.10 percent of the original principal amount of the mortgage (but not in excess of $2,500). This fee, which is not at issue, appears to compensate petitioner for the type of services for which the taxpayer received commitment fees in *Chesapeake Fin. Corp. v. Commissioner,* 78 T.C. 869, 1982 WL 11098 (1982).

18 Loans are not sales transactions. “When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer.” *Commissioner v. Tufts,* 461 U.S. 300, 307, 103 S.Ct. 1826, 75 L.Ed.2d 863 (1983). Petitioner did not make loans to the originators; instead, petitioner agreed to purchase a mortgage from the originators.

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Federal Home Loan Mortg. Corp. v. C.I.R., 125 T.C. No. 12 (2005)

125 T.C. 248, Tax Ct. Rep. (CCH) 56,199, Tax Ct. Rep. Dec. (RIA) 125.12

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Ajay Gupta
Financial Products Taxation
Reading #11

Conversion Transactions and Constructive Sales

Code: §§ 1258 and 1259.

Treatise: Keyes, Federal Taxation of Financial Instruments & Transactions, Chapters 19 and 20 (Extract) (Attached).

Gupta, Ajay 4/11/2021
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Fed. Tax. Fin. Instruments & Transactions ¶ 19.02

***1 Federal Taxation of Financial Instruments & Transactions**

October 2020

Keyes

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Part IV. Financial Transactions

Chapter 19. Conversion Transactions

19.02 “CONVERSION TRANSACTION” DEFINED

The first order of business under Section 1258 is to determine whether a conversion transaction is present. Section 1258(c) defines “conversion transaction” as a transaction that meets two tests: (1) Substantially all of the taxpayer's return is attributable to the time value of money and (2) the transaction falls within one of four specified categories.

19.02[1] Return Based on Time Value of Money

As stated in the legislative history, a distinguishing characteristic of a conversion transaction is that the taxpayer is in the economic position of a lender. In this transaction, the taxpayer's expected return is, in substance, in the nature of interest, and no significant risks are undertaken other than those that are typical of a lender. [4] Accordingly, the first test is whether substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the transaction. [5] Thus, if no substantial certainty as to the lender's return exists, the transaction should not constitute a conversion transaction. [6] Further, the legislative history indicates that Section 1258 does not apply if the taxpayer does not have a net investment in the transaction. [7]

19.02[2] Categories of Transactions

The second defining aspect of a conversion transaction is that it must fit within at least one of four categories of transactions. This aspect of the definition promises to be extraordinarily difficult to apply in practice. The categories overlap and the intended scope of each is uncertain at best.

The first transaction category contemplates a taxpayer holding property and entering into a contract to sell it (or substantially identical property) at a price specified in the contract, provided the property in the contract is entered into on a “substantially contemporaneous basis.” [8] The second category encompasses “applicable straddles,” [9] which are defined as a “straddle” under Section 1092(c), except that in defining “straddle” for purposes of the conversion transaction provision, stock is also treated as personal property. [10] The third category is a transaction that is marketed or sold to the taxpayer on the basis that it would have the economic characteristics of a loan but that the interest-like return would be taxed as capital gain. [11] Finally, the fourth category encompasses any transactions described as a conversion transaction in future regulations. [12]

As demonstrated in the legislative history, a conversion transaction would generally arise where the taxpayer holds stock and enters into a forward contract to sell that stock.

Example 19-1

***2** Assume that on January 1, 1994, Individual *A* purchases stock for $100 and on the same day agrees to sell that stock to Individual *B* for $115 two years later on January 1, 1996. A's return reflects the time-value of money and falls within the first and possibly second transaction categories. It is therefore a conversion transaction. [13]

In addition, it appears that a forward conversion transaction would generally fall within the scope of Section 1258. This strategy contemplates three separate positions with respect to the common stock of a corporation:

- *1. The purchase of a block of the corporation's common stock;*
- *2. The purchase of a put option on a similar quantity of the same stock; and*
- *3. The sale of a call option on a similar quantity of the same stock.*

Both the put and the call usually have the same expiration date and exercise price.

Example 19-2

Taxpayer A acquires 100 shares of the common stock of *X* Corporation for $49 per share on Day 1. Also on Day 1, *A* purchases for $200 the right to put 100 shares of *X* stock to a third party at a price of $50 per share on or before Day 91. A also sells a call on 100 shares of *X* common stock for $300, which entitles a third party to purchase from A the 100 shares of *X* stock at a price of $50 per share on or before Day 91.

If the price of the underlying stock stayed below the exercise price of the options as of the exercise date, the taxpayer would exercise its put option and sell the stock at the exercise price. Conversely, if the price of the stock should rise above the exercise price, the holder of the call option on the stock would exercise his call option and require the taxpayer to sell the stock at the exercise price. In either case, the taxpayer is reasonably assured of receiving a $200 return on its net investment of $4,800 ($5,000 − $4,800 ($4,900 + $200 − $300). Thus, the transaction likely constitutes a conversion transaction.

Footnotes

4 1993 House Report at 636–637; 1993 Senate Print at 55.
5 IRC § 1258(c)(2). The term “net investment” is discussed infra ¶ 16.03[1][a][i].
6 1993 House Report at 636–637; 1993 Senate Print at 51.
7 See 1993 House Report at 636–637; 1993 Senate Print at 57.
8 IRC § 1258(c)(2)(A).
9 IRC § 1258(c)(2)(B).

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10 IRC § 1258(d)(1). For a discussion of straddles, see Chapter 15. In Legal Advice Issued by Field Attorneys LAFA 20131701F, the Service concluded that a prepaid forward contract and a credit linked note constituted a straddle having a return that was attributable to the time value of money. As a result, Section 1258 applied to treat gain on the forward contract as ordinary income that could not be offset by the taxpayer's capital losses.

In Chief Counsel Advice 201501012, the Service concluded that the form of a transaction marketed as a “leveraged forward contract” could be disregarded, so that interest deductions claimed by the taxpayer would be disallowed.

In this transaction, a broker sold a prepaid forward contract to the taxpayer and lent the taxpayer the amount needed to pay the forward purchase price. Payments on the loan and forward contract offset so that no actual cash changed hands. The transaction was marketed as generating interest deductions and capital gains. Because of certain features in the forward contract, the broker entered into swaption contracts (paid for by the taxpayer) in the event additional payments were required if interest rates exceeded specific protected rates.

The Service disregarded the transaction's form and determined that the individuals were not permitted to claim interest deductions from the transaction on their federal income tax return. Under an alternative argument, the Service also determined that the Section 465 at-risk rules disallow some or all of the deductions. According to the Service, the contracts failed to function as forward contracts because payment provisions in the contracts do not obligate the individuals to buy or sell assets in the future at a predetermined price.

The Service further concluded that Section 1258 applies to the transaction. The Service noted that the contract payments matched the loan's principal and interest and that the payments were a return of the individuals' net investment in the contract, payable at a fixed interest rate. According to the Service, the transaction was a conversion transaction because the expected gain from the contracts is solely attributable to the time value of money and the contract was marketed as producing capital gains.

11 IRC § 1258(c)(2)(C).

12 IRC § 1258(c)(2)(D).

13 1993 House Report at 638–639.

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Part IV. Financial Transactions

Chapter 19. Conversion Transactions

19.03 OPERATION OF THE CONVERSION PROVISIONS

Section 1258, capital gain realized on a conversion transaction is generally recharacterized as ordinary income (but not as interest). However, the amount of gain to be recharacterized is subject to the limitations discussed below. In addition, the legislative history states that income retains its character as capital gain for such purposes as the unrelated business income tax (UBIT) for tax-exempt organizations and the gross income requirement for regulated investment companies (RICs). [14]

19.03[1] Amount of Gain Recharacterized

Section 1258(a) recharacterizes gain that otherwise would be treated as capital gain on the disposition or termination of any position held as part of the conversion transaction. The amount of gain so recharacterized cannot exceed the applicable imputed income amount (AIIA).

19.03[1][a] Applicable Imputed Income Amount

The AIIA is the amount of interest that would have accrued on the taxpayer's net investment in the transaction for the period ending on the disposition or termination (or, if earlier, the date the transaction ceases to be a conversion transaction), as reduced by amounts previously treated as ordinary income with respect to prior dispositions of positions in the transaction.“ [15] This hypothetical interest is deemed to accrue at a rate equal to 120 percent of the applicable rate. [16] As described below, the AIIA may be adjusted for capitalized expenses and other items.

19.03[1][a][i] Computing net investment.

To calculate the AIIA, the taxpayer must first determine the net investment in the transaction. The legislative history provides that a taxpayer's net investment in the transaction is the aggregate amount invested by the taxpayer in the conversion transaction, less any amount received by the taxpayer as consideration for entering into any position held as part of the conversion transaction (e.g., a premium received upon granting an option). [17] Future commitments to provide funds or capital will generally not be treated as an investment until the time that the funds are committed to the transaction and are unavailable to the taxpayer to

invest in other ways. [18] Further, a taxpayer's net investment is not reduced by the fact that the taxpayer borrowed to acquire property included in the transaction. [19]

In determining the net investment, positions that become part of a conversion transaction are taken into account at their fair market value, as determined at the time it becomes part of the conversion transaction. [20] A special rule applies if "built-in loss" property becomes part of a conversion transaction. For this purpose, the term "built-in loss" means the loss, if any, that would have been realized if the position had been disposed of or otherwise terminated at its fair market value as of the time the position became part of the conversion transaction. [21]

***2** Section 1258(d)(3)(i) states that any position having a built-in loss when it becomes part of a conversion transaction is taken into account, for all federal income tax purposes, at its fair market value as of the time it became part of the transaction. Notwithstanding this statement, Section 1258(d)(3)(A)(ii) goes on to provide that if the position is disposed of or terminated in a transaction in which gain or loss is recognized, the built-in loss is nevertheless recognized and has a character determined without regard to Section 1258.

19.03[1][a][ii] Applicable rate.

Under Section 1258(d)(2), if the conversion transaction has a definite term, the applicable rate is the applicable federal rate (AFR) as determined under Section 1274(d) at the time the taxpayer enters into the conversion transaction. [22] If the conversion transaction has an indefinite term, then the applicable rate is the federal short-term rate determined under Section 6621(b) during the period of the conversion transaction. [23]

19.03[1][a][iii] Reduction for capitalized expenses and other items.

Section 1258(b) directs the Treasury to issue regulations under which the AIIA is reduced to reflect, as appropriate, amounts capitalized under Section 263(g) (e.g., interest on acquisition indebtedness). Under the regulations, the AIIA should also be reduced for ordinary income received by the taxpayer and other appropriate items. [24]

19.03[1][b] Comprehensive Illustrations

The examples below, taken from the legislative history, serve to illustrate the operation of Section 1258. They are useful not only in identifying conversion transactions, but also in illustrating the tax consequences of such transactions. Example 19-3 illustrates the general operation of Section 1258.

Example 19-3

Assume that on January 1, 1994, Individual A purchases stock for $100 and on the same day agrees to sell that stock to Individual *B* for $115 two years later on January 1, 1996. Also assume that the AFR is 5 percent compounded annually. On January 1, 1996, *A* delivers the stock to *B* for the agreed price of $115 per share. Prior to Section 1258, *A* would recognize capital gain of $15 on the disposition of the stock. Section 1258, however, recharacterizes a portion of the gain as ordinary income. In this example, the amount A invested was $100 and the applicable rate is determined by compounding 120 percent of 5 percent for

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two years. Applying this rate to *A* 's net investment ($100) produces ordinary income of $12.36. The remaining gain of $2.64 is taxed as capital gain. [25]

The example below depicts a case where the taxpayer borrows to acquire a position in a conversion transaction. The example demonstrates the impact of borrowing on the taxpayer's net investment and the amount of gain recharacterized.

Example 19-4

Assume the same facts as in Example 19-3, except that *A* borrows $90 of the purchase price of the stock from a bank and is required under Section 263(g) to capitalize $10 of interest on that debt into the cost of the stock. *A* 's net investment in the transaction is still $100, even though *A* 's basis is increased to $110 to reflect the capitalized interest of $10. However, of the gain of $5, only $2.36 will be recharacterized as ordinary income, since the AIIA of $12.36 is reduced by the $10 of capitalized interest. [26]

***3** The next example highlights the computation of a net investment where the taxpayer receives a premium upon selling an option. It also serves to illustrate the nature of the return that must be present in a conversion transaction.

Example 19-5

Assume that on January 1, 1994, Individual *X* acquires publicly traded common stock for $100 and on the same day grants a call option on the same stock for $106 to Individual *Y* . The option is exercisable any time prior to February 1, 1995, and *Y* pays a premium of $10. At the time *X* grants the call option, there is no substantial certainty that *Y* will exercise the option.

Under these facts, *X* 's net investment in the transaction comprised of the stock purchase and the granting of the option would be $90 (i.e., the $100 paid for the stock minus the $10 received for granting the option). *X*′ s return on the investment will be $16 if *Y* exercises the call option (the excess of $106 of sales proceeds over the net investment of $90). However, if *Y* does not exercise the option, *X* 's return will be the difference between $90 and the value of the stock on February 1, 1995. Thus, the stock purchase and the grant of the option is a transaction having risks that are not typical of a lender. Therefore, it is not a conversion transaction. [27]

The application of Section 1258 where built-in loss property is present is discussed in the following example.

Example 19-6

Assume the same facts as in Example 19-5, except that prior to January 1, 1994, Individual *X* had purchased the stock in Example 19-5 for $150 and had used it as part of a conversion transaction entered into on January 1, 1994, when the stock's value had declined to $100. Under these facts, the stock would be treated as having a $100 basis for purposes of Section 1258, and the results would be the same as in Example 19-5, except that *X* would also recognize the $50 built-in loss when the asset was delivered to *Y* . The character of that $50 loss would not be affected by this provision. [28]

Finally, Example 19-7 describes a case where future financial commitment on the taxpayer's part is required. It also illustrates the definition of “conversion transaction.”

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Example 19-7

Assume that on January 1, 1994, Individual *X* enters into a long futures contract committing *X* to purchase a certain quantity of gold on March 1, 1994, for $1,000. Also on January 1, 1994, *X* enters into a short futures contract to sell the same quantity of gold on April I, 1994, for $1,006. Under these contracts, *X* is not required to make an investment at the time they are entered into, but is required to make a "margin" deposit (which may or may not bear interest) as security for his obligations thereunder. Suppose *X* terminates both contracts on February 1, 1994, for a net profit of $2. No part of that $2 is subject to recharacterization under this provision, since *X* has no investment in the transaction on which the $2 could be considered to be an interest-equivalent return. [29]

19.03[2] Netting Gains and Losses From Conversion Transactions

19.03[2][a] Character Mismatch Problem

***4** As mentioned at the beginning of this chapter, the purpose of Section 1258is to identify and treat as ordinary income the portion of gain from a conversion transaction that is attributable to the time value of money. Commentators have noted that Section 1258 will produce too much ordinary income if gains and losses on the disposition of conversion positions cannot be netted together. [30] Moreover, the inability to net gains and losses creates a character mismatch between ordinary income and capital losses, as illustrated below.

Example 19-8

Assume that a taxpayer buys a capital asset for $100 and simultaneously sells that asset forward for $105 in one year. Also assume that the AIIA is $8. If the asset were delivered to close out the forward contract, the taxpayer would have a $5 capital gain. Even though the AIIA is $8, no more than the $5 gain would be recharacterized.

However, assume that the taxpayer sells the asset and closes out the forward contract in separate transactions when the value of the asset has dropped to $97. Also assume that the gain subject to recharacterization on the forward contract is $8. If the $3 loss on the asset is not netted against that $8 gain prior to applying Section 1258(a), the full $8 gain will be recharacterized as ordinary income. As a result, this recharacterization would force the taxpayer to recognize $8 of ordinary income and $3 of nonoffsetting capital loss. [31]

19.03[2][b] Relief for Identified Netting Transaction

Proposed regulations have been issued to provide relief from this character mismatch problem. Specifically, the regulations offer taxpayers a method to net certain gains and losses from positions of the same conversion transaction before determining the amount of gain treated as ordinary income under Section 1258(a). [32] This relief provision applies if a taxpayer disposes of or terminates all of the positions of an "identified netting transaction" within a fourteen-day period in a single taxable year. If this test is met, then all gains and losses on those positions realized within that period (other than certain built-in losses) are netted. Importantly, this netting applies solely for purposes of determining the amount of gain treated as ordinary income under Section 1258(a). [33]

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An "identified netting transaction" is defined as a conversion transaction that the taxpayer identifies as an identified netting transaction on its books and records. Identification of each position of the conversion transaction must be made before the close of the day on which the position becomes part of the conversion transaction. [34] The example below illustrates the netting rule.

Example 19-9

On December 1, 1995, Individual *A* purchase 1,000 shares of *XYZ* stock for $100,000 and enters into a forward contract to sell 1,000 shares of *XYZ* stock on November 30, 1997, for $110,000. On that day, *A* identifies the two positions as all the positions of a single conversion transaction on his books and records. *A* owns no other XYZ stock. On December 1, 1996, when the applicable imputed income amount for the transaction is $7,000, *A* sells the 1,000 shares of *XYZ* stock for $95,000. On the same day, *A* terminates his forward contract by entering into an offsetting position and receiving $10,200.

***5** The *XYZ* stock and forward contract are positions of a conversion transaction. Under Section 1258(c)(1), substantially all of *A* 's expected return from the overall transaction is attributable to the time value of the net investment in the transaction. The transaction is an applicable straddle and thus, taken together, constitutes a conversion transaction.

In addition, the transaction is an identified netting transaction, since *A* disposed of or terminated all the positions of the conversion transaction within fourteen days and within the same taxable year. Thus, solely for purposes of Section 1258(a), the taxpayer's gain is $5,200 ($10,200 (gain) − $5,000 (loss)). Only the $5,200 net gain is recharacterized as ordinary income under Section 1258(a), even though the AIIA is $7,000. [35]

19.03[2][c] Special Rules for Built-In Losses

As mentioned earlier, the special netting rules do not apply to built-in loss inherent in a conversion position. For this purpose, a position has a built-in loss if loss would have been realized upon the disposition or termination of the position at its fair market value when it became part of the conversion transaction. [36]

Example 19-10

Assume the same facts as in Example 19-9, except that Individual *A* purchased the *XYZ* stock for $104,000 on May 15, 1995, and that the *XYZ* stock had a fair market value of $100,000 on December 1, 1995, when it became part of the conversion transaction.

The results are the same as in Example 19-9, except that *A* has $4,000 built-in loss (in addition to the $5,000 loss that arose economically during the period of the conversion transaction). *A* cannot net the $4,000 built-in loss against the $10,200 gain on the forward contract for purposes of Section 1258(a). Thus, the net gain from the conversion transaction for purposes of Section 1258(a) is $5,200, the same as in Example 19-9. However, the $4,000 built-in loss is recognized and has a character determined without regard to Section 1258. [37]

The proposed regulations state that built-in loss also arises where a taxpayer realizes gain or loss on any one position of a conversion transaction (e.g., under Section 1256) and, as of the date such items are realized, there is unrealized loss in any other position of the conversion transaction that is not disposed of, terminated, or treated as sold within the prescribed fourteen-day period. In this event, the unrealized loss in the latter position constitutes built-in loss.

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Example 19-11

Individual *B is* a calendar year taxpayer that holds a portfolio of Treasury securities that constitute capital assets in *B* 's hands. On December 1, 1995, *B* enters into a short regulated futures contract (RFC) on Treasury securities. The RFC and some portion of *B* 's portfolio of Treasury securities (the conversion Treasuries) constitute a straddle as defined in Section 1092(c). However, *B* does not make an election out of Section 1256, [38] nor does *B* make any identification or election under (relating to certain identified mixed straddles or mixed straddle accounts). [39] On December 1, 1995, *B* identities on his books and records the conversion Treasuries and the RFC as all the positions of a single conversion transaction.

***6** As of December 29, 1995, the last business day of the taxable year, *B* has an unrealized loss on the conversion Treasuries of $8,000, wholly attributable to the period beginning December 1, 1995, and ending December 29, 1995, and an unrealized gain on the RFC of $8,800. *B* marks-to-market the securities as required by Section 1256. *B* continues to hold the conversion Treasuries.

The conversion Treasuries and RFC are positions of a conversion transaction. Under Section 1258(c)(1), substantially all of *B* 's expected return from the overall transaction is attributable to the time value of the net investment in the transaction. Under Section 1258(c)(2)(B), the transaction is an applicable straddle as defined in Section 1258(d)(1).

The transaction is also an identified netting transaction. However, the netting rule is not available, because *B* did not dispose of or terminate all the positions of the conversion transaction within the same fourteen-day period in the same taxable year. That is, there has been no disposition or termination of the conversion Treasuries by December 31, 1995, the end of *B* 's taxable year in which it is treated as having sold the RFC. Thus, the $8,000 excess of *B* 's basis in the conversion Treasuries over their fair market value on December 29, 1995, is built-in loss that is not available to offset later gain on the positions. [40]

Footnotes

14 See 1993 House Report at 637–638, note 1; 1993 Senate Print at 55, note 1.
15 IRC §§ 1258(b)(1), 1258(b)(2).
16 IRC § 1258(b)(2).
17 1993 House Report at 637–638; 1993 Senate Print at 57.
18 1993 House Report at 637–638.
19 See 1993 House Report at 637–638; 1993 Senate Print at 56.
20 IRC § 1258(d)(4).
21 IRC § 1258(d)(3)(B).
22 More precisely, the rate is determined as if the transaction were a debt instrument, with an AFR based on semi-annual compounding or its equivalent. IRC § 1258(d)(2)(A). The Treasury has the authority under Section 1274(d)(1)(D) to provide for the use of an applicable rate lower than the AFR in appropriate cases. HR Conf. Rep. No. 213, 103d Cong., 1st Sess. 574–575 (1993) (hereinafter 1993 Conference Report).
23 IRC § 1258(d)(2)(B).
24 IRC § 1258(b). Although regulations have not been issued, the statute appears to be self-executing and should operate in the manner set forth in the legislative history.
25 1993 House Report at 636–637.
26 1993 House Report at 636–637; 1993 Senate Print at 56.

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27 1993 House Report at 637–638.
28 Id.
29 Id.
30 Taggart & Ritrivi, "Coping With the Confusing Anti-Conversion Provisions of RRA '93," 80 J. Tax'n 38 (Jan. 1994).
31 Prop. Reg. § 1.1258-1(Preamble).
32 Prop. Reg. § 1.1258-1(a).
33 Prop. Reg. § 1.1258-1(b)(1). A taxpayer is still treated as disposing of any position that is treated as sold under any provision of the Code or regulations (e.g., under Section 1256(a)(1)).
34 Prop. Reg. § 1.1258-1(b)(2). No particular form of identification is necessary, but all the positions of a single conversion transaction must be identified as part of the same transaction and must be distinguished from all other positions.
35 Prop. Reg. § 1.1258-1(d), Ex. 1. The example notes that the *XYZ* stock is actively traded as defined in Regulation § 1.1092(d)-1(a) and is a capital asset in *A*'s hands. Thus, for federal tax purposes other than Section 1258(a), *A* has recognized a $10,200 gain on the disposition of the forward contract ($5,200 of which is treated as ordinary income) and has realized a separate $5,000 loss on the sale of the *XYZ*stock.
36 Prop. Reg. § 1.1258-1(c)(adopting the Section 1258(d)(3)(B) definition).
37 Prop. Reg. § 1.1258-1(d), Ex. 2.
38 See IRC § 1256(d).
39 See Reg. § 1.1092(b)-3T (identified Section 1092(b) mixed straddle election) or § 1.1092(b)-4T (election to employ mixed straddle account), respectively.
40 Prop. Reg. § 1.1258-1(d), Ex. 3.

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Fed. Tax. Fin. Instruments & Transactions ¶ 20.02

***1 Federal Taxation of Financial Instruments & Transactions**

October 2020

Keyes

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Part IV. Financial Transactions

Chapter 20. Constructive Sales and Variable Prepaid Forward Contracts

20.02 CONSEQUENCES OF A CONSTRUCTIVE SALE

If a constructive sale occurs, then the taxpayer recognizes the gain in the appreciated financial position as if it were sold at its fair market value on the date of the constructive sale and immediately repurchased. [9] The amount of any gain or loss subsequently realized on the position is adjusted to reflect the gain recognized on the constructive sale. [10] The taxpayer's holding period in the position is reset and begins anew as if the taxpayer had first acquired the position on the date of the constructive sale.

Footnotes

9 IRC § 1259(a)(1). The gain is recognized and taken into account for the tax year that includes the date of the constructive sale.

10 IRC § 1259(a)(2)(A). As a practical matter, if appropriate, the taxpayer could adjust its basis in the position to reflect the recognized gain. See S. Rep. No. 105-33, at 124 (1997).

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***1 Federal Taxation of Financial Instruments & Transactions**

October 2020

Keyes

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Part IV. Financial Transactions

Chapter 20. Constructive Sales and Variable Prepaid Forward Contracts

20.03 CONSTRUCTIVE SALE DEFINED

20.03[1] Appreciated Financial Position

A constructive sale occurs if a taxpayer holds an appreciated financial position and enters into certain offsetting transactions with respect to the same or substantially identical property. A constructive sale can take place only with respect to an appreciated financial position. "Appreciated" means that there would be gain if such position were sold, assigned, or otherwise terminated at its fair market value. [11]

An appreciated financial position is any position with respect to a stock, debt instrument, or partnership interest. [12] A position is an interest in the financial asset, including a futures or forward contract, a short sale, or an option. [13] A position includes any other type of derivative instrument under which the taxpayer will receive and make payments, or contractual credits, that approximate the economic effect of owning the stock, the debt, or the partnership interest, such as a total NPC. [14] An interest in a trust that is actively traded (as defined in Section 1092(d)(1)) is treated as stock unless substantially all (as measured by value) of the property held in the trust is debt that is not treated as an appreciated financial position. [15]

Debt and a position with respect to debt are not treated as an appreciated financial position if the following conditions are satisfied:

- *The debt instrument (or position) unconditionally entitles the holder to receive a specified principal amount*
- *The interest payments (or similar amounts) with respect to such position are payable based on a fixed rate or variable rate*
- *The debt instrument is not convertible (directly or indirectly) into stock of the issuer or a related person* [16]

A hedge of a position in debt that is not treated as a position for purposes of Section 1259 is also not treated as a position for purposes of Section 1259. [17] A position in debt that does not satisfy the exception for debt or a hedge of such debt position, including one identified as part of a hedging or straddle transaction, can be an appreciated financial position. [18]

An appreciated financial position does not include a position that is marked to market under Section 475 or Section 1256 or any other provision of the Code or regulations. [19]

20.03[2] Constructive Sale Transactions

A taxpayer is treated as constructively selling an appreciated financial position if the taxpayer or a related person enters into one of the following offsetting transactions with respect to the same or substantially identical property (as the appreciated financial position):

***2** • *A short sale*

• *An offsetting NPC*

• *A futures or forward contract*

• *Acquires the same or substantially identical property, if the appreciated financial position is a short sale, an offsetting NPC, or a futures or forward contract*

• *To the extent prescribed in regulations, one or more other transactions (or the acquisition of one or more positions) that have substantially the same effect as one of the offsetting transactions* [20]

An offsetting transaction that results in a constructive sale of one appreciated financial position is not a constructive sale of another appreciated financial position while the taxpayer holds the appreciated financial position that was constructively sold. If the taxpayer disposes of the constructively sold appreciated financial position while the offsetting transaction is open (with respect to the taxpayer or a related person), then the open offsetting transaction is treated as being entered into immediately after such disposition, which can result in the constructive sale of another appreciated financial position. [21] For example, if a taxpayer holds two appreciated stock positions, one of which was constructively sold because of an offsetting short sale, then selling the stock position that was constructively sold while the short sale is open would cause a constructive sale of the other appreciated stock position. [22]

There is a rule regarding multiple positions in property. If a taxpayer holds multiple positions in property, then the taxpayer determines whether a specific transaction is a constructive sale in the same manner as an actual sale. Likewise, if there is a constructive sale, then the taxpayer determines the appreciated financial position that is deemed sold in the same manner as an actual sale. [23] The first part of the rule appears to permit a taxpayer to determine whether a transaction is a constructive sale if the taxpayer owns both an appreciated financial position and the same or substantially identical property that is not appreciated. [24] The second part of the rule is clear that if a taxpayer owns multiple appreciated financial positions of the same or substantially identical property, then the taxpayer may select which of the appreciated financial positions will be treated as constructively sold. [25] Although there is no specific guidance as to how a taxpayer should effectuate the identification, placing a statement in the taxpayer's books and records that identifies the financial position that is associated with the offsetting transaction ought to suffice. It is prudent to make the identification by the close of the day on which the constructive sale takes place or would take place if the financial position offset by the transaction were an appreciated financial position. [26]

***3** The legislative history states that Congress intends that Section 1259 can apply to transactions that are identified as hedging transactions or straddle transactions. [27] The constructive sale is treated as having occurred immediately before the identified

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transaction and the relevant rules to the identified hedging transaction or straddle transaction apply.[28] A constructive sale may take place after the establishment of the identified hedging transaction or straddle transaction. In that case, the gain in the appreciated financial position is recognized and accounted for under the relevant hedging or straddle rule.[29]

20.03[2][a] Related Person

A person is related to another person with respect to a transaction if the parties are related under Section 267(b) or Section 707(b), and the transaction is entered into with a view toward avoiding Section 1259.

20.03[2][b] Forward Contract

A forward contract is a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.[30] A contract under which the amount of property to be delivered is subject to significant variation is not within the definition of a forward contract for purposes of Section 1259.[31] An agreement subject to contingencies that would prevent the agreement from being a contract under the applicable contract law is not a contract for purposes of the rule.[32]

20.03[2][c] Offsetting NPC

An offsetting NPC is an agreement with respect to property that includes the following:

- *A requirement to pay (or a provision of credit for) all or substantially all of the investment yield (including appreciation) on such property for a specified period*

- *A right to be reimbursed (or to receive credit) for all or substantially all of any decline in the value of such property*[33]

20.03[2][d] Collars and Other Transactions

Transactions that would trigger a constructive sale are to include those identified in regulations that have substantially the same effect as one of statutorily specified transactions. The legislative history discusses some criteria that the Treasury should consider under its regulatory authority. For example, it says that such a transaction should have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to the appreciated financial position. A transaction that eliminates only risk of loss would not be such a transaction.[34]

Although no regulations have been promulgated, the legislative history contains a discussion of collar transactions that provides the only guidance as to whether a collar transaction may be treated as a forward sale for purposes of the statute. If a taxpayer were to purchase a put option and write a call option, both of which have the same strike prices, then the taxpayer would have two positions that, when combined, are economically equivalent to a forward sale contract at the strike price; the combined positions would be treated as a forward contract for purposes of Section 1259. Even if the two positions were not entered into at the same time, when the taxpayer entered into the second position, that second transaction would result in a constructive sale.[35] The legislative history notes that a collar can be a single contract or a combination of puts and calls.[36] When a collar is evidenced as a single contract, the put strike price is also known as the floor price and the call strike price is also known as the cap price.

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***4** The legislative history says that the Treasury regulations are expected to address collars and that such guidance would be prospective, except in cases to prevent abuse. [37] It describes a collar with a put strike price of $95 and a call strike price of $110 when the stock is trading at $100, and says that the seller has retained all risk of loss and opportunity for gain in the price range between $95 and $110. [38]

The issue with a collar is that even in the absence of regulations it may be treated as a forward contract if it has the effect of eliminating substantially all of a taxpayer's risk loss or opportunity for gain. The legislative history gives little guidance as to when a collar may be treated as a forward contract in the absence of regulations. A collar with a narrow spread between the floor and cap price may be treated as a contract to deliver a "substantially fixed amount of property (including cash) for a substantially fixed price." [39] Similarly, if the floor price is significantly above the current market value or the cap price is significantly below the current market value, then the collar may be treated as a forward contract because the contract has transferred substantially all risk of loss and opportunity for gain with respect to the appreciated financial position. [40]

The mismatch between the value of the appreciated financial position and the collar price was an issue in *Estate of McKelvey v. Commissioner* . [41] The taxpayer had modified the terms of two variable prepaid forward contracts (VPFCs) that when entered into were not treated as actual sales or constructive sales of appreciated stock that the taxpayer owned. [42] The Second Circuit concluded that the modifications resulted in new contracts. [43] The Internal Revenue Service (the Service) asserted that the new contracts were constructive sales of the taxpayer's appreciated stock position because of the pricing of the contracts. At the time one of the contracts was modified, the share price of the underlying stock was approximately $18.24, the floor price under that contract was $30.4610, and the cap price was $40.5809. [44] When the other contract was modified, the share price was $17.28 and the floor price and the cap price were $30.894 and $35.772, respectively. The court addressed the Service's constructive sale position by applying a probability analysis to assess the likelihood that the share price would appreciate to the floor price by the end of the VPFCs. The probability that the share price would be less than the floor price was approximately 85 percent to 87 percent under the two contracts. Based on that analysis, the court held that the numbers of shares to be delivered under the contracts were substantially fixed and the modified contracts resulted in constructive sales of the taxpayer's appreciated stock position. [45]

20.03[2][e] Exceptions

***5** There are two exceptions to the constructive sale rules. One exception is for certain transactions involving nonmarketable securities, and the other is for certain closed transactions.

20.03[2][e][i] Nonmarketable securities.

A constructive sale does not include a contract for sale of any stock, debt instrument, or partnership interest that is not a marketable security (as defined in Section 453(f)) if the contract settles within one year after the date the contract is entered into. [46]

20.03[2][e][ii] Closed transactions.

If the offsetting transaction is closed no later than the thirtieth day after the close of the tax year in which it was entered into and the taxpayer continues to hold the appreciated financial position for a sixty-day period without reducing risk of loss in that

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position, then a constructive sale is treated as not having taken place. The following requirements must be met to satisfy the closed transaction exception:

- *The offsetting transaction is closed no later than the thirtieth day after the close of the tax year in which the offsetting transaction was entered into*
- *The taxpayer holds the appreciated financial position throughout the sixty-day period that begins on the date the offsetting transaction is closed*
- *During that sixty-day period, the taxpayer's risk of loss is not reduced by holding a position described in Section 246(c)(4) (with respect to the appreciated financial position)* [47]

The sixty-day period during which the taxpayer's risk of loss may not be reduced is reset to a new sixty-day period if, during the original sixty-day period, the following occurs:

- *The taxpayer enters into a new offsetting transaction that would be a constructive sale*
- *The new offsetting transaction is closed no later than the thirtieth day after the close of the tax year (in which the original offsetting position was entered into)*
- *The taxpayer holds the appreciated financial position for the sixty-day period that begins on the date the new offsetting transaction is closed*
- *During that sixty-day period, the no-risk reduction requirement previously described is satisfied* [48]

The risk reduction positions described in Section 246(c)(4) are the following:

- *The taxpayer has an option to sell, is under a contract to sell, or has made and not closed a short sale of, substantially identical property*
- *The taxpayer is the grantor of an option to buy substantially identical property*
- *As provided for in regulations, the taxpayer has diminished his or her risk of loss by holding one or more positions with respect to the substantially similar or related property* [49]

Footnotes

11 IRC § 1259(b)(1).
12 IRC § 1259(b)(1).
13 IRC § 1259(b)(2).
14 See IRC § 1259(c)(1)(B); 1997 Bluebook at 175.

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15 IRC § 1259(e)(2). Regulation Section 1.1092(d)-1 defines "actively traded." See Chapter 17 for the discussion of straddles and related transactions, and ¶ 17.02 specifically for the definition of "straddle."

16 IRC § 1259(b)(2)(A). To satisfy the interest requirement for purposes of the exception, the interest must satisfy the requirements of Section 860G(a)(1)(B)(i). The requirements for variable interest are contained in Regulation Section 1.860G-1(a)(3). The interest may be contingent on certain interest payments on a pool of mortgages; it cannot be contingent on profits of the borrower, the borrower's discretion, or similar factors. See H.R. Rep. No. 105-148, at 442 (1997).

17 IRC § 1259(b)(2)(B). A hedge of debt that comes within this definition is a position that reduces the taxpayer's risk of interest rate or price changes or currency fluctuations with respect to another position. 1997 Bluebook at 175.

18 H.R. Rep. No. 105-220, at 514 (1997) (Conf. Rep.); S. Rep. No. 105-33, at 125 (1997); 1997 Bluebook at 175.

19 IRC § 1259(b)(2)(C).

20 IRC § 1259(c)(1). To date, there are no regulations under Section 1259.

21 IRC § 1259(e)(1); S. Rep. No. 105-33, at 125 (1997); H.R. Rep. No. 105-148, at 441 (1997). An assignment or other termination is treated as a disposition. IRC § 1259(e)(1).

22 S. Rep. No. 105-33, at 125 (1997); 1997 H.R. Rep. No. 105-148, at 441 (1997).

23 IRC § 1259(e)(3); S. Rep. No. 105-33, at 125 (1997); 1997 H.R. Rep. No. 105-148, at 441 (1997).

24 The legislative history does not clarify the rule. It seems to say that a transaction would have to be allocated across multiple positions, but the discussion is cryptic, and it is silent about the taxpayer's ability to select among positions in contrast to the statute itself: "Where the standard for a constructive sale is met with respect to only a pro rata portion of a taxpayer's appreciated financial position (e.g., some, but not all, shares of stock), that portion will be treated as constructively sold under the provision." S. Rep. No. 105-33, at 125 (1997).

25 S. Rep. No. 105-33, at 125 (1997); H.R. Rep. No. 105-148, at 441 (1997).

26 See Reg. §§ 1.1012-1(c)(2), 1.1012-1(c)(4)(i)(a) (providing the identification rules if stock is sold and not held by a broker). Various identification rules require an identification to be done by the close of the business day on which the relevant transaction is entered into. E.g., Reg. § 1.1221-2(f) (identification requirements for a hedging transaction); IRC § 1092(a)(2)(B) (identification requirement for an identified straddle); IRC § 475(b)(2).

27 H.R. Rep. No. 105-220, at 513–514 (1997) (Conf. Rep.); 1997 Bluebook at 176–177.

28 H.R. Rep. No. 105-220, at 513–514 (1997) (Conf. Rep.); 1997 Bluebook at 176–177.

29 H.R. Rep. No. 105-220, at 513–514 (1997) (Conf. Rep.); 1997 Bluebook at 176–177. The reports also said it is intended "that future Treasury regulations may except certain transactions from the constructive sale provision where the gain recognized would be deferred under an identified hedging or straddle provision (e.g. Treas. Reg. sec. 1.446-4(b))." H.R. Rep. No. 105-220, at 514 (1997) (Conf. Rep.); 1997 Bluebook at 177.

30 IRC § 1259(d)(1).

31 S. Rep. No. 105-33, at 125–126 (1997); H.R. Rep. No. 105-148, at 442 (1997); 1997 Bluebook at 176.

32 H.R. Rep. No. 105-220, at 513 (1997) (Conf. Rep.).

33 IRC § 1259(d)(2).

34 S. Rep. No. 105-33, at 126 (1997); H.R. Rep. No. 105-148, at 442 (1997).

35 S. Rep. No. 105-33, at 124 (1997); H.R. Rep. No. 105-148, at 440 (1997); 1997 Bluebook at 176.

36 S. Rep. No. 105-33, at 126–127 (1997); H.R. Rep. No. 105-148, at 443 (1997); 1997 Bluebook at 178.

37 H.R. Rep. No. 105-220, at 514 (1997) (Conf. Rep.); S. Rep. No. 105-33, at 127 (1997); H.R. Rep. No. 105-148, at 443 (1997); 1997 Bluebook at 178.

38 S. Rep. No. 105-33, at 126–127 (1997); H.R. Rep. No. 105-148, at 443 (1997); 1997 Bluebook at 178.

39 Given the absence of any indication that Congress thought that the example collar used in the legislative history was problematic, that example may be a useful guide.

40 S. Rep. No. 105-33, at 127 (1997); H.R. Rep. No. 105-148, at 444 (1997); 1997 Bluebook at 178.

41 Estate of McKelvey v. Comm'r, 906 F3d 26 (2d Cir. 2018), rev'g 184 TC 312 (2017) . See ¶ 3.05[1][f] for discussion of this case.

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42 VPFCs are discussed at ¶ 20.04.

43 Estate of McKelvey v. Comm'r, 906 F3d 26, 35 (2d Cir. 2018).

44 If, on settlement, the share price was less than the floor price, then the taxpayer was required to deliver a fixed number of shares. If the share price was between the floor price and the cap price, then the total number of shares would decline to a specified fixed number if the share price was at the cap price, and if the share price was above the cap price, then the number of shared would increase as the share price increased to the maximum number of shares. Estate of McKelvey v. Comm'r, 906 F3d 26, 29–30 (2d Cir. 2018).

45 Estate of McKelvey v. Comm'r, 906 F3d 26, 40 (2d Cir. 2018).

46 IRC § 1259(c)(2). A "marketable securities" means any security for which there is a market on an established securities market or otherwise. IRC § 453(f)(2). The term "established securities market"

includes (A) a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f), (B) an exchange which is exempted from registration under section 5 of the Securities Exchange Act of 1934 (15 U.S.C. 78e) because of the limited volume of transactions, and (C) any over-the-counter market. For purposes of this (iv), an over-the-counter market is 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 obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of business and containing only quotations of such broker or dealer.Reg. § 15a.453-1(e)(4)(iv).

47 IRC § 1259(c)(3)(A).

48 IRC § 1259(c)(3)(B).

49 See ¶ 2.03[3] for a discussion of Section 246(c)(4). Regulation Section 1.246-5 provides the rules implementing Section 246(c)(4)(C).

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Financial Products Taxation
Reading #12

Constructive Sales

Code: § 1259

Rev. Rul. 2003-7

Estate of McKelvey v. Commissioner, 906 F.3d 26 (2d Cir. 2018).

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Rev. Rul. 2003-7 (IRS RRU), 2003-5 I.R.B. 363, 2003-1 C.B. 363, 2003 WL 124818

Internal Revenue Service (I.R.S.)

IRS RRU
Revenue Ruling

ACTUAL AND CONSTRUCTIVE SALES

Released: January 16, 2003
Published: February 3, 2003

Section 1001.--Determination of Amount of and Recognition of Gain or Loss, *26 CFR 1.1001-1:Determination and recognition of gain or loss.*

(Also § 1259.)

***1 Actual and constructive sales.** This ruling holds that a shareholder has neither sold stock currently under section 1001 of the Code nor caused a constructive sale of stock under section 1259 if the shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not otherwise economically compelled to deliver the pledged shares.

Actual and constructive sales. This ruling holds that a shareholder has neither sold stock currently under section 1001 of the Code nor caused a constructive sale of stock under section 1259 if the shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not otherwise economically compelled to deliver the pledged shares.

ISSUES

Has a shareholder either sold stock currently or caused a constructive sale of stock under § 1259 of the Internal Revenue Code if the shareholder (1) receives a fixed amount of cash, (2) simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, (3) pledges the maximum number of shares for which delivery could be required under the agreement, (4) has 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) is not economically compelled to deliver the pledged shares?

FACTS

An individual (“Shareholder”) held shares of common stock in *Y* corporation, which is publicly traded. Shareholder's basis in the shares of *Y* corporation is less than $20 per share. On September 15, 2002 (the “Execution Date”), Shareholder entered into an arm's length agreement (the “Agreement”) with Investment Bank, at which time a share of common stock in *Y* corporation had a fair market value of $20. Shareholder received $*z* of cash upon execution of the Agreement. In return, Shareholder became

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obligated to deliver to Investment Bank on September 15, 2005 (the "Exchange Date"), a number of shares of common stock of *Y* corporation to be determined by a formula. Under the formula, if the market price of a share of *Y* corporation common stock is less than $20 on the Exchange Date, Investment Bank will receive 100 shares of common stock. If the market price of a share is at least $20 and no more than $25 on the Exchange Date, Investment Bank will receive a number of shares having a total market value equal to $2000. If the market price of a share exceeds $25 on the Exchange Date, Investment Bank will receive 80 shares of common stock. In addition, Shareholder has the right to deliver to Investment Bank on the Exchange Date cash equal to the value of the common stock that Shareholder would otherwise be required to deliver under the formula.

In order to secure Shareholder's obligations under the Agreement, Shareholder pledged to Investment Bank on the Execution Date 100 shares (that is, the maximum number of shares that Shareholder could be required to deliver under the Agreement). Shareholder effected this pledge by transferring the shares in trust to a third-party trustee, unrelated to Investment Bank. Under the declaration of trust, Shareholder retained the right to vote the pledged shares and to receive dividends.

Under the Agreement, Shareholder had the unrestricted legal right to deliver the pledged shares, cash, or shares other than the pledged shares to satisfy its obligation under the Agreement. Shareholder is not otherwise economically compelled to deliver the pledged shares. At the time Shareholder and Investment Bank entered into the Agreement, however, Shareholder intended to deliver the pledged shares to Investment Bank on the Exchange Date in order to satisfy Shareholder's obligations under the Agreement.

LAW AND ANALYSIS

Section 1001(c) provides that, except as otherwise provided in subtitle A of the Code, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized. The Code does not define a "sale or exchange." The courts have considered many factors significant in determining whether a sale or other disposition of property has occurred. The factors that are relevant, and the weight to be accorded to each factor, must be determined in light of the nature of the property involved. *See Torres v. Commissioner*, 88 T.C. 702, 721 (1987).

Several cases have addressed the transfer of securities to a brokerage firm under a subordination agreement intended to allow the brokerage firm to use the securities to meet its net capital requirements under stock exchange rules. *See*, *e.g.*, *Cruttenden v. U.S.*, 644 F.2d 1368 (9th Cir. 1981); *Lorch v. Commissioner*, 70 T.C. 674 (1978), *aff'd*, 605 F.2d 657 (2d Cir. 1979), *cert. denied*, 444 U.S. 1076 (1980); *Miami National Bank v. Commissioner*, 67 T.C. 793 (1977). In these cases, an owner of marketable securities transferred legal title and actual possession of the securities to the brokerage firm, which held the securities in a subordination account under an agreement that permitted the brokerage firm to sell the securities if necessary to meet claims of general creditors of the brokerage firm. The transferor, however, retained the right to receive dividends and the right to vote any stock. In addition, the transferor could reacquire the securities in the subordination account by substituting either cash or other securities of equivalent value.

In *Miami National Bank*, the court held that despite the right of the brokerage firm to sell stock in a subordination account to satisfy its creditors, the transferor remained the owner of the stock. As a result, the court held that the transferor's subsequent sale of the stock in the subordination account was effective to permit the purchaser to be treated as the direct owner of the stock for purposes of the consolidated return ownership test. At all times, the transferor had the right to reacquire the stock in the subordination account by substituting cash or other readily marketable securities of equivalent value. The court gave significant weight to this right in holding that the creation of the subordination account did not cause the brokerage firm to become the owner of the stock in the subordination account. The court noted that the transferor's right of substitution was not "merely an idle one" because, at all times, the transferor possessed sufficient resources to exercise the right. In fact, after the brokerage firm became insolvent, the transferor substituted cash for the stock. Thus, *Miami National Bank* and other similar cases indicate

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that a transfer of actual possession of stock or securities and legal title may not itself be sufficient to constitute a transfer of beneficial ownership when the transferor retains the unrestricted right and ability to reacquire the securities.

In cases addressing short sales of stock or securities, the courts have refused to recognize covering purchases as triggering a sale because, until actual delivery, the taxpayer retains the unrestricted right to dispose of the covering shares. *See*, *e.g.*, *Richardson v. Commissioner*, 121 F.2d 1 (2d Cir.), *cert. denied*, 314 U.S. 684 (1941). In a typical short sale, the taxpayer borrows stock or securities to effect a short sale and is under an obligation to return identical stock or securities to the lender. In *Richardson*, the taxpayer entered into numerous sales, which were generally short sales effected with borrowed stock. In one case, the taxpayer purchased 7,100 shares of stock that were intended to be used to close out a short sale but were in fact delivered to close out a different sale. Despite the taxpayer's intent to use the purchased stock to close his earliest open short sale, and despite a showing that he followed a consistent practice of applying purchases to close out his earliest open short sale, the taxpayer was held not to have closed a short sale because the stock was not actually delivered to the stock lender. Noting that the taxpayer had not entered into any agreement or understanding with the lender of the 7,100 shares and had not otherwise placed himself in a position in which he was not entitled to treat the purchased shares as long stock and sell them for his own account, the court stated:

> [The covering shares] remained under control of the taxpayer and up to the time of actual delivery could have been sold and replaced by other purchases in the absence of prior agreement with the lender to use them to make restitution. Such a shifting intent to cover a short sale ought not to be the critical event which would determine gain or loss under a tax statute. It would leave the whole matter of fixing the event to the taxpayer's own will. We hold that the time of delivery was the time at which the covering transactions must be regarded as closed.

Richardson at 4. *Accord Klinger v. Commissioner*, No. 18315 (T.C.M. 1949). Thus, *Richardson* supports the conclusion that even if the shareholder intends to complete a sale by delivering identified stock, that intent alone does not cause a transaction to be deemed a sale, as long as the taxpayer retains the right to determine whether the identified stock will in fact be delivered.

By contrast, in *Hope v. Commissioner*, 55 T.C. 1020 (1971), *aff'd*, 471 F.2d 738 (3d Cir.), *cert. denied*, 414 U.S. 824 (1973), the Tax Court, in determining that a sale had occurred, relied on the seller's receipt of sales proceeds and the purchaser's receipt of title and possession of shares without restriction in use. In that case, the taxpayer was the owner of approximately 57% of the common stock of a company that had recently become a publicly traded company, and was having difficulty in disposing of his remaining large block of stock. The taxpayer made an arrangement with an investment bank for a sale at a price that was approximately one half of the price at which the stock was currently trading. Under the arrangement, the investment bank earned its fee by reselling 25% of the block of stock to the general public. The investment bank held the remainder of the stock subject to options to purchase the stock at the investment bank's cost and subject to proxy agreements that transferred to the optionees the right to vote the shares for the election of directors. Half of the options and proxy rights were held by the taxpayer's brother; the other half were held by two individuals who were employees of the company. Subsequent to the closing of the transaction, the taxpayer became dissatisfied with the sale price and brought a suit for rescission. The litigation was not concluded in the year of the transaction. On advice of counsel, the taxpayer held the sales proceeds in cash and marketable securities pending settlement of the litigation. On his tax return for the year of the transfer, the taxpayer disclosed the transfer but did not include in income his gain on the sale on the ground that the transfer was not a completed sale on which gain was recognized.

The court concluded that the transaction constituted a sale of the entire block:

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> The facts of this case conclusively establish that on July 27, 1960, the petitioner sold 206,400 shares of … stock to [an investment bank] as agent for several purchasers as well as for its own account. The sale was completed on that date when title and possession of the certificates were transferred by the petitioner to [the investment bank], and the petitioner received $4,000,032 as payment in full…. The petitioner received the money from the sale without any restrictions on his use or disposition of those funds.

55 T.C. at 1029.

In the present case, on the Execution Date, Shareholder received a fixed payment without any restriction on its use and also transferred in trust the maximum number of shares that might be required to be delivered under the Agreement. Like the taxpayers in *Miami National Bank* and *Richardson*, but unlike the taxpayer in *Hope*, Shareholder retained the right to receive dividends and exercise voting rights with respect to the pledged shares. Also unlike *Hope*, the legal title to, and actual possession of, the shares were transferred to an unrelated trustee rather than to Investment Bank. Moreover, Shareholder was not required by the terms of the Agreement to surrender the shares to Investment Bank on the Exchange Date. Rather, Shareholder had a right, unrestricted by agreement or economic circumstances, to reacquire the shares on the Exchange Date by delivering cash or other shares. *See Miami National Bank* and *Richardson.* Accordingly, the execution of the Agreement did not cause a sale or other disposition of the shares.

A different outcome may be warranted if a shareholder is under any legal restraint or requirement or under any economic compulsion to deliver pledged shares rather than to exercise a right to deliver cash or other shares. For example, restrictions placed upon a shareholder's right to own pledged common stock after the Exchange Date, or an expectation that a shareholder will lack sufficient resources to exercise the right to deliver cash or shares other than pledged shares, would be significant factors to be weighed in determining whether a sale has occurred.

Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale. Under § 1259(b), the term "appreciated financial position" means any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value. Furthermore, for purposes of § 1259, the term "position" means an interest, including a futures or forward contract, short sale, or option. Under § 1259(c)(1)(C), a taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) enters into a futures or forward contract to deliver the same or substantially identical property. The term "forward contract" is defined under § 1259(d)(1) as a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price. The legislative history indicates that a forward contact that provides for the delivery of an amount of stock that is subject to "significant variation" under the terms of the contract is not within the statutory definition of a forward contract. S.Rep. No. 33, 105th Cong., 1st Sess. 125-26 (1997), 1997-4 (Vol. 2) C.B. 1067, 1205-06.

Under these facts, the Agreement does not cause a constructive sale of the shares under § 1259(c)(1)(C). According to the Agreement, delivery of a number of shares, which may vary between 80 and 100 shares, depends on the fair market value of the stock on the Exchange Date. Because this variation in the number of shares that may be delivered under the Agreement is a significant variation, the Agreement is not a contract to deliver a substantially fixed amount of property for purposes of § 1259(d)(1). As a result, the Agreement does not meet the definition of a forward contract under § 1259(d)(1) and does not cause a constructive sale under § 1259(c)(1)(C).

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Gupta, Ajay 4/7/2023
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HOLDING

Shareholder has neither sold stock currently nor caused a constructive sale of stock if Shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not economically compelled to deliver the pledged shares.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Christina Morrison and Mary Truchly of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Ms. Morrison at (202) 622-3950 or Ms. Truchly at (202) 622-3960 (not toll-free calls).

Rev. Rul. 2003-7 (IRS RRU), 2003-5 I.R.B. 363, 2003-1 C.B. 363, 2003 WL 124818

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oranda and (2) the Clearwater certificates on the basis of Utica's proven liability under its umbrella policies issued to Goulds.

ESTATE OF Andrew J. MCKELVEY, Deceased, Bradford G. Peters, Executor, Petitioner – Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent – Appellant.

Docket No. 17-2554
August Term 2017

United States Court of Appeals, Second Circuit.

Argued: June 5, 2018

Decided: September 26, 2018

Background: Executor of taxpayer's estate petitioned for redetermination of income-tax deficiency arising from variable prepaid forward contracts (VPFC), which IRS contended resulted in short- and long-term capital gains on grounds that taxpayer's exchanges of original for extended contracts were taxable exchanges and constructive sales. The Tax Court, Ruwe, J., entered decision for taxpayer. IRS appealed.

Holdings: The Court of Appeals, Jon O. Newman, Circuit Judge, held that:

(1) Court of Appeals would remand to Tax Court for determination in the first instance whether replacement of obligations in original VPFCs with obligations in new contracts, i.e. the extensions, satisfied criteria for termination of obligations giving rise to taxable income, presumably short-term capital gains, and

(2) taxpayer's extensions to VPFCs constituted constructive sales that triggered realization of long-term capital gains.

Reversed and remanded.

José A. Cabranes, Circuit Judge, filed concurring opinion.

1. Internal Revenue ⚿4705

Court of Appeals reviews de novo Tax Court decisions rendered on a stipulated record.

2. Internal Revenue ⚿3179

Taxpayer's replacement of variable prepaid forward contracts (VPFC) in which banks agreed to pay him money equal to value of pledged shares of stock discounted to present value and taxpayer agreed to deliver up to a maximum number of shares or their cash equivalent on a specified valuation date, with amended contracts extending the settlement and valuation dates, was not an exchange of property, and thus, taxpayer did not incur short-term capital gain on basis of the replacement; at time VPFCs were extended, taxpayer no longer had any rights in the contracts that could constitute property, as he had already received the prepayments from the banks, nothing else was owed to him, and he had only the obligation to deliver the pledged shares or their cash equivalent to the banks. 26 U.S.C.A. § 1001(c).

3. Internal Revenue ⚿3179

Taxpayer's extension of valuation dates of variable prepaid forward contracts (VPFC), in which banks agreed to pay him money equal to value of pledged shares of stock discounted to present value and taxpayer agreed to deliver up to a maximum number of shares or their cash equivalent on a specified valuation date,

resulted in amended contracts that replaced the original contracts, which could, if amended contracts accomplished a termination of taxpayer's obligations under the VPFCs, result in short-term capital gains for income tax purposes; by extending the valuation dates, parties fundamentally changed bets that VPFCs represented, from bets on value of stock on original valuation date to bets on value of stock on new valuation dates. 26 U.S.C.A. § 1001.

4. Contracts ⚿246

A sufficiently fundamental or material change to an original contract that results in a change in the fundamental substance of the original contract will be considered an exchange of the original contract for the amended contract.

5. Internal Revenue ⚿4756

Court of Appeals would remand to Tax Court taxpayer's case, petitioning for redetermination of income tax deficiencies arising out of IRS's determination that extension of valuation dates of variable prepaid forward contracts (VPFC) resulted in short- and long-term capital gains, for determination in the first instance whether replacement of obligations in original VPFCs with obligations in new contracts, i.e. the extensions, satisfied criteria for a termination of obligations giving rise to taxable income, presumably short-term capital gains given that extensions were executed within a year after execution of the VPFCs, and if so, the amount of such gain; Tax Court did not consider termination-of-obligation argument, and parties differed on whether amended contracts accomplished a termination of obligations under the VPFCs. 26 U.S.C.A. § 1001.

6. Internal Revenue ⚿3179

Taxpayer's extensions to variable prepaid forward contracts (VPFC) in which bank agreed to pay him money equal to value of pledged shares of stock discounted to present value and taxpayer agreed to deliver up to a maximum number of shares or their cash equivalent on a specified valuations date, constituted constructive sales that triggered realization of long-term capital gains; taxpayer pledged appreciated stock and the amount of those collateralized shares to be delivered at settlement of each amended contract was substantially fixed on date when each such amended contract, i.e. the extensions, was executed, because closing price of the stock had fallen so far below floor price of each contract that there was remote chance price would recover and exceed floor price by the valuation date. 26 U.S.C.A. § 1259(d)(1).

7. Internal Revenue ⚿3027

Tax laws are to be applied with an eye to economic realities.

Appeal from the United States Tax Court

Clint A. Carpenter, (David A. Hubbert, Deputy Asst. Atty. General, Gilbert S. Rothenberg, Joan I. Oppenheimer, on the brief), Tax Division, Appellate Section, U.S. Dep't. of Justice, Washington, D.C., for Respondent-Appellant Commissioner of Internal Revenue.

Mark D. Lanpher, (Robert A. Rudnick, Kristen M. Garry, on the brief), Shearman & Sterling LLP, Washington, D.C., for Petitioner-Appellee Estate of Andrew J. McKelvey.

Before: NEWMAN, CABRANES, and CARNEY, Circuit Judges.

JON O. NEWMAN, Circuit Judge:

This appeal concerns somewhat unusual financial instruments known as variable prepaid forward contracts ("VPFCs"). A VPFC is an agreement between a short party (typically, the shareholder of a large

quantity of low-basis, appreciated stock) and a long party (typically an investment bank). The long party agrees to pay the shareholder a substantial sum of money equal to the value of the stock discounted to present value. In exchange, the shareholder agrees to deliver to the long party on a specified settlement date up to a maximum number of shares of stock (or their cash equivalent), the exact number to be determined by the price of the shares on a specified valuation date. The short party also agrees to secure its delivery obligation with the maximum number of shares to be delivered at settlement. A VPFC usually sets a floor price and a cap price that limit the number of shares to be delivered in the event that the share price on the valuation date is below the floor price, above the cap price, or between them. The issues on this appeal arise because a shareholder, after executing two similar VPFCs with two financial institutions, paid substantial sums of money to each institution to obtain an extension of the settlement date and, more significantly, the valuation date.

There are two precise issues. The first is whether, with respect to each contract, the extensions resulted in a short-term capital gain. The Commissioner of Internal Revenue ("Commissioner") contends that a short-term capital gain occurred because either (1) the extension of the valuation date resulted in an exchange of property with a more valuable new contract replacing the original contract or (2) a termination of the delivery obligation occurred because the obligation in the first contract to deliver shares on the original settlement date was extinguished.

The second issue is whether, with respect to each contract, the extension of the valuation date also resulted in a long-term capital gain. The Commissioner contends that the execution of each new contract resulted in a constructive sale of the shares pledged as collateral to secure the obligation of the new contract. His reason for this claim is that, on the date of the new contract, the share price of the stock pledged as collateral was so far below the floor price that there was no more than a fifteen and thirteen percent probability, respectively, for each contract that the share price would reach that floor price and therefore, under each contract, the shareholder would almost certainly be required to deliver the maximum number of collateralized shares. As a result, the Commissioner contends, the number of shares to be delivered at settlement was "substantially fixed" within the meaning of 26 U.S.C. § 1259(d)(1) on the date of each new contract, resulting in a long-term capital gain on shares constructively sold.

These rather esoteric issues arise on an appeal by the Commissioner from the May 22, 2017, decision of the United States Tax Court (Robert P. Ruwe, Judge) rejecting the Commissioner's claims to collect $41,257,103 from the estate of Andrew J. McKelvey ("Estate") for both short- and long-term capital gain taxes alleged to have been incurred by the decedent in 2008.

Background

McKelvey, who died on November 27, 2008, was the founder and principal shareholder of Monster Worldwide, Inc. ("Monster"), a publicly traded company that maintains a website, monster.com, which helps job-seekers find jobs. In 2007, McKelvey executed two VPFCs, one with Bank of America, N.A. ("BofA") as long party and another with Morgan Stanley & Co. International plc ("MSI") as long party.

The BofA VPFC. Under the BofA contract, which became effective September 11, 2007, BofA agreed to pay McKelvey

$50,943,578.31 on September 14, 2007; he agreed to pledge 1,765,188 shares of Monster stock to secure his obligation to BofA; and he agreed to deliver to BofA *up to* 1,765,188 shares of Monster stock (or the cash equivalent) at settlement. Settlement was to be made by delivering to BofA up to ten percent of the 1,765,188 shares on each of ten consecutive weekdays between September 11 and 24, 2008. At the close of trading on the NASDAQ on September 11, 2007, the price of Monster stock was $32.91.

The contract provided that the actual number of shares to be delivered on each of the ten settlement dates would be determined in one of three ways, depending on the closing price of Monster stock on each of the ten dates. If the closing price on a settlement date was *less* than (or equal to) $30.4610 ("BofA floor price"), the number of shares to be delivered on each of the ten dates would be 176,519 (ten percent of 1,765,188).[1] If the closing price on a settlement date was *more than* the BofA floor price but *less than* (or equal to) $40.5809 ("BofA cap price"), the number of shares to be delivered on each of the ten dates would be a fraction of 176,519: the numerator of the fraction would be the BofA floor price and the denominator would be the Monster stock closing price. If the closing price on a settlement date was *more than* the BofA cap price, the number of shares to be delivered would be a more complicated fraction of 176,519: the numerator of the fraction would be the closing price minus the difference between the BofA cap price and the BofA floor price, and the denominator would be the closing price.

These three methods of determining the number of shares to be delivered at settlement would yield curious results. To illustrate these results, it will be convenient to ignore the fact that ten percent of the total number of the 1,765,188 shares would be delivered on each of ten consecutive weekdays and consider the collateralized shares as a bloc. If the closing price was equal to, or any price below, the floor price, the number of shares to be delivered would always be the total number of shares pledged as collateral, which would be the maximum number of shares required to be delivered at settlement. If the closing price was between the floor price and the cap price, the number of shares to be delivered would *decline* from 1,765,188 the closer the closing price was to the cap price. The decline would end when the closing price equaled the cap price, at which point the number of shares to be delivered would be 1,324,993 (1,765,188 times 30.4610/40.5809).[2] If the closing price was any price above the cap price, the number of shares to be delivered would *increase* from 1,324,993 and continue to increase the more the closing exceeded the cap price. The increase would be continuous as the closing price increased and the number of shares to be delivered approached the total number of the collateralized shares, but the number of shares to be delivered would never exceed that maximum total number. These effects are illustrated in the following table, showing an example of how many shares of a 1,000-share bloc would be delivered at various closing prices: some below or equal to the floor price of 30.5 (rounded), some between the floor price and the cap price of 40.6 (rounded), and some above the cap price. The table also shows the fraction used to

1. The number of shares for the first two dates was 176,518 and for the next eight days was 176,519 so that the total equaled 1,765,188. This slight variation applied to all three methods of determining the number of shares to be delivered at settlement.

2. *See* footnote 9, *infra*.

determine the number of shares to be delivered.

closing price:	20	25	30.5	35	40	40.6	45	50	60
fraction:				30.5/35	30.5/40	30.5/40.6	34.9/45	39.9/50	49.1/60
shares delivered :	1000	1000	1000	850	763	751	776	798	818

Under the BofA contract, McKelvey had the option to settle the contract with the "cash equivalent" no matter which of the three methods for determining the number of shares to be delivered was applicable. The cash equivalent for each share to be delivered was 105 percent of the closing share price three trading days prior to the valuation date for the first portion of the collaterized shares to be delivered, which was September 11, 2008.[3] Of course, had McKelvey used the cash equivalent option (for both the BofA and MSI contracts), he would have had to pay a substantial sum of money.

On July 24, 2008, two months before the ten settlement dates, McKelvey paid BofA $3,477,949.92 to amend the BofA contract by extending the original settlement dates, which also served as valuation dates, from ten consecutive weekdays in September 2008 to ten consecutive weekdays in February 2010 ("amended contract"). No other terms of the 2007 BofA contract were changed. On the date of the BofA extension, the closing price of Monster stock was $18.24.

The MSI VPFC. Under the MSI contract, effective September 24, 2007, MSI agreed to pay McKelvey $142,626,185.80 on September 27, 2007; he agreed to pledge 4,762,000 Monster shares to secure his obligation to MSI; and he agreed to deliver to MSI *up to* 4,762,000 Monster shares (or the cash equivalent) on September 24, 2008. At the close of trading on the NASDAQ on September 24, 2007, the price of Monster stock was $33.47.

The contract provided that the actual number of shares to be delivered on the settlement date would be determined in one of three ways depending on the average of the closing prices of Monster stock on ten valuation dates ("average price"). If the average price was *less* than (or equal to) $30.894 ("MSI floor price"), the number of shares to be delivered would be 4,762,000. If the average price was *more than* the MSI floor price but *less than* (or equal to) $35.772 ("MSI cap price"), the number of shares to be delivered would be a fraction of 4,762,000, the numerator of the fraction to be the MSI floor price and the denominator to be the average price. If the average price was *more than* the MSI cap

3. This simplified explanation is derived from several provisions of the original BofA contract, all of which were carried forward into the amended contract with the valuation dates extended. "If Party B [McKelvey] elects Cash Settlement ... Party B shall pay the Preliminary Forward Cash Settlement Amount to Party A [BofA] on the Preliminary Cash Settlement Payment Date." The Preliminary Forward Cash Settlement Amount is defined as "The sum of all the Daily Preliminary Forward Cash Settlement Amounts," and the "Preliminary Cash Settlement Payment Date" is defined as "The Currency Business Day immediately following the Preliminary Cash Settlement Pricing Date." The Daily Preliminary Forward Cash Settlement Amount is defined as "105% of the Forward Cash Settlement Amount that would apply if the Valuation Date were the Preliminary Cash Settlement Pricing Date." The Preliminary Cash Settlement Pricing Date is defined as "The third Scheduled Trading Day immediately prior to the Scheduled Valuation Date for the Component with the earliest scheduled Valuation Date." The earliest scheduled Valuation Date for the first component, *i.e.,* 10 percent of the collateralized shares was September 11, 2008.

price, the number of shares to be delivered would be a more complicated fraction of 4,762,000: the numerator of the fraction would be the average price minus the difference between the MSI cap price and the MSI floor price, and the denominator would be the average price. These three methods of calculation yielded precisely the same curious results described above with respect to the BofA contract when the closing price was equal to or below the MSI floor price, above the MSI cap price, or between them.

Under the MSI contract, like the BofA contract, McKelvey had the option to settle the contract with the "cash equivalent" no matter which of the three methods for determining the number of shares to be delivered was applicable, but the calculation of the cash equivalent differed from the BofA contract. Under the MSI contract, the cash equivalent was the number of shares to be delivered multiplied by the closing price of Monster stock on the last of the ten averaging dates.[4] That date was September 24, 2008.

On July 15, 2008, two months before the settlement date, McKelvey paid MSI $8,190,640 to amend the MSI contract by extending the original settlement date from September 24, 2007, to January 15, 2010, and to extend the dates on which the average price would be determined from ten consecutive weekdays in September 2008 to ten consecutive weekdays in January 2010 ("amended contract"). No other terms of the 2007 MSI contract were changed. On the date of the MSI extension, the closing price of Monster stock was $17.28.

On the dates of the extensions of both the BofA and MSI contracts, the value of McKelvey's Monster shares was about $114 million. If McKelvey had delivered his Monster shares on those dates instead of extending the settlement and valuation dates of the VPFCs, he would have realized a substantial capital gain.

Settlement of amended contracts. After McKelvey's death, the Estate settled the amended BofA contract by delivering 1,757,016 Monster shares to BofA on May 8, 2009,[5] and settled the amended MSI contract by delivering 4,762,000 Monster shares to MSI on August 5, 2009. Both the original VPFCs and the amended contracts provided for expedited settlement in the event of various occurrences including McKelvey's death. The parties make no claim that the expedited settlements have any significance to the issues on appeal. The Estate obtained a stepped-up basis for the Monster shares. *See* 26 U.S.C. § 1014(a)(1).

To recapitulate: by executing both VPFCs in September 2007, McKelvey re-

4. This simplified explanation is derived from two sources. The original MSI contract, with the valuation date extended by the amended contract, provided that "If Cash Settlement applies, then on the Cash Settlement Payment Date, Counterparty [McKelvey] shall pay to MSI plc the Forward Cash Settlement Amount," which "shall be determined in accordance with the Equity Definitions" of the International Swaps and Derivatives Assn., Inc. ("ISDA"). Under the relevant Equity Definitions, Forward Cash Settlement Amount means "an amount equal to the Number of Shares to be Delivered ... multiplied by the Settlement Price," § 8.5(f), ISDA, "2002 ISDA Equity Derivatives Definitions" 25 (2002), and Settlement Price means "the price per Share ... as of ... the Valuation Date, § 7.3(a), *id.* at 22. The MSI contract specified that the Valuation Date was September 24, 2008.

5. The parties do not explain why the total number of shares delivered to BofA at settlement, 1,757,016, was slightly less than the anticipated total number of shares, 1,765,188, to be delivered if the closing price was below the floor price in the BofA contract, which it was.

ceived about $194 million,[6] pledged about 6.5 million Monster shares,[7] then worth about $218 million,[8] and agreed to deliver one year later between about 5.4 million [9] and 6.5 million Monster shares (then worth between about $181 million [10] and $218 million). Ten months later, McKelvey paid $11,668,590 to execute amended contracts, which extended the settlement dates and the valuation dates that would determine the number of shares to be delivered at settlement. The Estate settled the amended contracts by delivering 6,519,016 Monster shares, which the Commissioner states were worth about $88 million, to BofA and MSI. Neither McKelvey nor the Estate paid any income taxes with respect to the Monster shares.

McKelvey's 2008 income tax return. McKelvey's 2008 federal income tax return, filed by the executor of his Estate, reported no income attributable to the execution of the amended contracts. The Estate's reason for not reporting any short-term capital gain was its view that the extensions of the settlement and valuation dates did not result in a taxable exchange of the original VPFCs for the amended contracts. The Estate's reason for not reporting any long-term capital gain was its view that such a gain could not have occurred until the amended contracts were settled by delivery of Monster shares to BofA and MSI, and, by that time, the shares had acquired a stepped-up basis following McKelvey's death, *see* 26 U.S.C. § 1014(a)(1), and the stock price had declined between the date of death and the settlement date.

The Commissioner's deficiency determination. The Commissioner determined a deficiency of more than $41 million in McKelvey's 2008 federal income tax based on his determination that McKelvey realized a capital gain of more than $200 million when he executed the VPFC extensions in 2008. This deficiency was based on two separate determinations. First, McKelvey realized a short-term capital gain because the extensions of the settlement and particularly the valuation dates resulted in taxable exchanges of the original VPFCs for the more valuable amended contracts, which the Commissioner deemed to be "forward contracts" within the meaning of 26 U.S.C. § 1259(d)(1).[11] Second, McKelvey realized a long-term

6. $50,943,578.31 BofA prepayment plus $142,626,185.80 MSI prepayment equals $193,569,564.11.

7. 1,765,188 shares in the BofA contract plus 4,762,000 shares in the MSI contract equals 6,527,188 shares.

8. 6.5 million times $33.47, the closing price of Monster stock on Sept. 24, 2007, equals $217,555,000.

9. Under the BofA and MSI contracts, McKelvey was obligated to deliver the minimum number of shares at settlement if the closing price at that time equaled the cap price. To determine the minimum number of shares in that circumstance, the applicable fraction for the BofA contract is $30.4610 (floor price)/$40.5809 (cap price), which is the smallest applicable fraction under the contract, applied to the number of shares pledged in the BofA contract, 1,765,188, which yields 1,324,993 shares. To determine the minimum number of MSI shares, the applicable fraction is 30.894 (floor price)/$35.77 (cap price) applied to the number of shares pledged in the MSI contract, 4,762,000, which yields 4,112,636 shares. Adding 1,324,993 to 4,112,636 yields 5,437,629 shares. The Commissioner's briefs to the Tax Court reported that the minimum number of shares to be delivered would be about 5.4 million shares.

10. 5.4 million times $33.47 equals $180,738,000.

11. Subsection 1259(d)(1) provides:

> "**Forward contract.**—The term 'forward contract' means a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price."

capital gain because the number of shares to be delivered at settlement of these forward contracts was "substantially fixed" within the meaning of subsection 1259(d)(1), resulting in constructive sales of the Monster shares that he had pledged as collateral under what the Commissioner deemed to be forward contracts. We set forth in more detail the Commissioner's rationale for these claims of capital gains below when we consider his arguments on this appeal.

The Tax Court decision. McKelvey's estate commenced a Tax Court action to challenge the Commissioner's determinations. On joint motion of the parties, the case was decided without trial based on stipulated facts. *See Estate of McKelvey v. Commissioner*, 148 T.C. No. 13, 2017 WL 1402129, at *1 (2017) ("TC op.").

The Tax Court began its consideration by noting that the execution of the VPFCs in 2007 did not result in recognition of any capital gains and would not result in any capital gains until the VFPCs were settled. The VPFCs were "open" transactions, *i.e.*, the identity of and the number of shares to be delivered at settlement was not substantially fixed because the taxpayer could substitute cash or non-collaterized stock to satisfy his delivery obligations and the amount of cash or stock to be delivered depended on the stock price at settlement. The Commissioner had previously acknowledged that VPFCs did not incur capital gains when executed. That position conformed to Revenue Ruling 2003-7, 2003-1 C.B. 363 (2003).

The Tax Court then noted that the ultimate issue to be decided was "what tax consequences, if any, occurred when [McKelvey] extended the settlement and averaging dates of the original VPFCs." TC op. 14, 2017 WL 1402129, at *4. Judge Ruwe observed that neither party had cited any decisions considering the tax consequences of extending VPFC valuation dates, and the case appeared to be one of first impression in the Tax Court. It is in this Court as well.

The Tax Court ruled in favor of the taxpayer on all issues. With respect to the claimed short-term capital gain, the Court held that the execution of the contracts was not a taxable "disposition of property" under 26 U.S.C. § 1001 because the VPFCs were not "property" to the taxpayer at the time they were exchanged for the amended contracts. *See id.* at 18-23, 2017 WL 1402129, at *6-*8. The Court explained that, at the time the amended contracts were signed, McKelvey had received the cash prepayment due him under each VPFC and "had only obligations under the contracts—and obligations are not property ... and therefore section 1001 is inapplicable." *Id.* at 20, 2017 WL 1402129, at *7.

Having concluded that the VPFCs were not property on the date of the amended contracts, the Tax Court did not consider the possibility that the execution of the amended contracts resulted in short-term capital gain on the theory that the obligations of the VPFCs had been terminated by the execution of the amended contracts. *See* 26 U.S.C. § 1234A(1).[12]

With respect to the claimed long-term capital gain, the Tax Court ruled that the amended contracts did not result in the constructive sale of the collateralized Monster shares under 26 U.S.C. § 1259. *See* TC op. at 35-36, 2017 WL 1402129, at *11-

12. Subsection 1234A(1) provides:

> "Gain or loss attributable to the cancellation ... or other termination of ... a right or obligation ... with respect to property which is ... a capital asset in the hands of the taxpayer ... shall be treated as gain or loss from the sale of a capital asset."

*12. The Court stated that the "open transaction treatment" under the VPFCs "continued" under the amended contracts, *see id.* at 36, 2017 WL 1402129, at *12, which the Court did not regard as forward contracts under section 1259(d)(1). The Tax Court also noted that because shares other than the Monster shares pledged as collateral could be used to settle the amended contracts, McKelvey "had the discretion to settle the VPFCs using stock with a higher or lower basis than the stock pledged as collateral." *Id.* at 30, 2017 WL 1402129, at *10.

Discussion

I. Standard of Review

[1] This Court reviews *de novo* Tax Court decisions rendered on a stipulated record. *See General Electric Co. v. Commissioner*, 245 F.3d 149, 154 (2d Cir. 2001). Generally, the Commissioner's determinations in a notice of deficiency are presumed correct, and the taxpayer bears the burden of proving them incorrect by a preponderance of the evidence. *See* Tax Ct. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115, 54 S.Ct. 8, 78 L.Ed. 212 (1933).

II. Short-Term Gain

[2] We agree with the Tax Court that McKelvey did not incur a short-term capital gain on the basis of the Commissioner's claim that replacement of the VPFCs with the amended contracts was an "exchange of property." 26 U.S.C. § 1001(c). At the time the VPFCs were extended, McKelvey no longer had any rights in the contracts that could constitute property. He had already received the $194 million prepayments from the banks, and nothing else was owed to him. He had only the obligation to deliver Monster shares (or their cash equivalent) to the banks in September 2008. As the Tax Court explained, "obligations are not property." TC Op. at 20, 2017 WL 1402129, *7.

Nevertheless, the Commissioner has an alternative claim that McKelvey realized a short-term gain because his obligation under each VPFC was terminated when he executed the amended contracts. "Gain . . . attributable to the cancellation . . . or other termination of . . . a right or obligation . . . with respect to property which is . . . a capital asset in the hands of the taxpayer . . . shall be treated as gain . . . from the sale of a capital asset." 26 U.S.C. § 1234A(1); *see Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311, 317 (5th Cir. 2015) (interpreting section 1234A(1) to mean that "[c]apital gain or loss results from the termination of contractual or derivative rights with respect to capital assets").

Although the Tax Court did not consider the termination-of-obligation argument, both parties agree that this Court may consider it. The Commissioner asserts that the termination issue "was placed squarely before the Tax Court by the [E]state itself," Brief for Commissioner at 52, and the Estate "does not dispute that this Court may consider the Commissioner's new arguments, given that the Estate explained below why the extensions did not result in a termination of Mr. McKelvey's obligations," Brief for Estate at 27. The parties differ, however, on whether the amended contracts accomplished a termination of McKelvey's obligations under the VPFCs. Normally, we would remand that issue in its entirety to the Tax Court, but because Judge Ruwe's opinion rejected a premise of the Commissioner's termination argument, we will consider the issue in part.

[3] The Commissioner contends, and the Estate disputes, that the VPFCs executed in 2007 were replaced by amended

contracts executed in July 2008. The Tax Court rejected this premise of the Commission's termination argument by stating, "[T]here is no merit to [the Commissioner's] contention that the extended VPFCs should be viewed as separate and comprehensive financial instruments." T.C. op. at 36, 2017 WL 1402129, at *12. This statement was made in the course of rejecting the Commissioner's claim that the extension of the valuation dates resulted in a constructive sale of the collateralized shares.

We agree with the Commissioner that extension of the valuation dates resulted in amended contracts that replaced the original contracts. The new valuation dates determined the share price upon which the number of shares to be delivered at settlement would be calculated, and these dates were seventeen months later than the dates for the original BofA contract and sixteen months later than the dates of the original MSI contract. As the Commissioner argues, "By extending the valuation dates, the parties fundamentally changed the bets that the VPFCs represented, from bets on the value of Monster stock in September 2008 to bets on the value of Monster stock in January and February 2010." Brief for Commissioner at 36.

[4] As the Estate acknowledged in the Tax Court, "a 'sufficiently fundamental or material change' to an original contract that results in 'a change in the fundamental substance of the original contract' will be considered an exchange of the original contract for the amended contract." Tax Court Brief for Estate at 43 (quoting Rev. Rul. 90-109, 1990-2 C.B. 191 (1990)). Extending the valuation dates was a fundamental change.

The new valuation dates in the amended contracts resulted in new contracts just as new expiration dates for option contracts result in new option contracts. The active trading of option contracts based on significant differences in expiration dates demonstrates that the options market regards different expiration dates as constituting different option contracts. As the report of the Commissioner's expert witness, Dr. Henrick Bessembinder, illustrates, on Sept. 11, 2007, the effective date of the BofA VPFC, call options for Monster stock with a strike price of $35 could be purchased for $0.35 if the expiration date was September 22, 2007, but cost $2.55 if the expiration date was January 19, 2008, and cost $6.10 if the expiration date was January 17, 2009.

In the pending case, McKelvey paid the banks approximately $11 million to obtain the new valuation dates. Obviously, he did not think he was making insignificant changes.

[5] Whether the replacement of the obligations in the original VPFCs with the obligations in what we hold are new contracts satisfies the criteria for a termination of obligations that gives rise to taxable income, presumably capital gain, and the amount of such gain are issues that we leave for determination in the first instance by the Tax Court on remand.[13]

III. Long-Term Capital Gain

The Commissioner renews on this appeal the argument he made to the Tax Court: the execution of the 2008 contracts extending the valuation dates resulted in the constructive sale of the shares pledged as collateral.

13. The parties recognize that this case concerns contracts that are non-debt instruments, and we make no implication as to the tax consequences of fundamental changes in debt instruments.

The Commissioner bases his claim of long-term gains on a statutory ground and a legal contention. The Commissioner's statutory ground is that a constructive sale under 26 U.S.C. § 1259 occurs when a taxpayer holds an "appreciated financial position" in stock and enters into a "forward contract to deliver the same or substantially identical property," 26 U.S.C. § 1259(c)(1)(C), and a "forward contract" is defined as "a contract to deliver *a substantially fixed amount of property* (including cash) at a substantially fixed price," *id.* § 1259(d)(1) (emphasis added).[14] There is no dispute that on the dates of the amended contracts all of McKelvey's Monster shares were an "appreciated financial position."[15]

[6] The Commissioner's legal contention, the disputed issue on the constructive sale portion of this appeal, is that the amount of Monster shares to be delivered at settlement of each amended contract was "substantially fixed" on the date when each amended contract was executed. His rationale is that, because the closing price of Monster stock on that date had fallen so far below the floor price of each contract ("deep in the money" in stock market parlance), there was only a remote chance that the price would recover and exceed the floor price by the valuation date. Based on this circumstance, the Commissioner contends that on the execution date of the amended contracts it was virtually certain that on the settlement date McKelvey would have to deliver all of the collateralized shares pledged under each amended contract, *i.e.*, 1,765,188 shares to BofA and 4,762,000 shares to MSI, which the contracts required if the Monster stock price closed below the floor price. That virtual certainty, the Commissioner concludes, means that, the amount of property to be delivered at settlement was "substantially fixed" within the meaning of subsection 1259(d)(1) and therefore the collateralized shares had been constructively sold.

The key step in the Commissioner's claim of constructive sales is his reliance on the remoteness of the possibility that the price of Monster stock would recover and exceed the floor price by the valuation date of each amended contract. He bases his reliance on Dr. Bessembinder's report (the "Report"). The Report used the so-called Black-Scholes formula, a formula widely used for determining the value of option contracts.[16] The Black-Scholes formula uses probability analysis, which, in addition to being used to price options, can also be used to determine the probability

14. The relevant Senate report explains the definition of forward contract from the opposite perspective, explaining that "a forward contract providing for delivery of an amount of property, such as shares of stock, *that is subject to significant variation* under the contract terms does not result in a constructive sale." S. Rep. 105-33, at 125-26 (1997) (emphasis added).

15. "Appreciated financial position" generally means "any position with respect to any stock . . . if there would be gain were such position sold . . . at its fair market value." 26 U.S.C. § 1259(b)(1).

16. The Black-Scholes formula, published in 1973 by three economists, Fischer Black, Myron Scholes, and Robert Merton, is "perhaps the world's most well-known options pricing model." Jean Folger, *Options Pricing: Black-Scholes Model*, https://www.investopedia.com/university/options-pricing/black-scholes-model.asp (last visited July 8, 2018). For their work, Scholes and Merton were awarded the 1997 Nobel Prize in Economics (Black was ineligible for the award because he had died, but the Nobel committee acknowledged his role). *See id.* The extremely complicated formula is shown in Folger, Figure 4, along with a typical calculator that can be used to apply the formula to the relevant factors, *id.*, Figure 5. *See also Black-Scholes model*, https://en.wikipedia.org/wiki/Black-Scholes_model (last visited July 8, 2018).

that a stock will reach a certain price by a certain date. The formula uses several factors: (1) the market price of the underlying stock on the valuation date, (2) the risk-free interest rate on the valuation date, (3) the period between the purchase of the option and the expiration, (4) the option strike price, (5) the volatility of the rate of change in the spot price of the underlying stock, and (6) the dividend yield.

Using the Black-Scholes formula, the Report stated that for the BofA amended contract "the probability that the settlement price on the expiration date would be greater than the floor price was approximately [*sic*] 14.90% immediately after the extension [of the valuation date], as compared to 52.78% when the contract was originated" and that the comparable figures for the MSI amended contract were 12.87% as compared to 53.62%. Joint App'x at 199.

Whether probability analysis may be used to determine that an amount of property is "substantially fixed" for purposes of subsection 1259(d)(1) is a novel question. Obviously, the modifier "substantially" informs us that the amount need not be exactly fixed and that Congress contemplated some leeway. A clear example of an amount substantially fixed would be an amount within a narrow range of limits. In the pending case, the amount is claimed to be substantially fixed for a different reason: the contract's amount of shares to be delivered is fixed whenever the closing price on the valuation date is below or equal to the floor price, and on the valuation date there was a very low probability that the closing price would reach the floor price before the settlement date. Although the Report presents the probability (for each contract) that the closing price will be equal to or above the floor price on the valuation date, we think the matter should be analyzed by using the reciprocals of the Report's percentages: there was a probability of 85.10% and 87.13% for the BofA and MSI amended contracts, respectively, that the closing price would be below the floor price on the settlement date.[17] The arithmetic is the same with either form of expression, but "substantially" in this context is better understood to mean substantially certain that the closing price will be below the floor price, rather than how unlikely it is that the closing price will equal or exceed the floor price.

Neither party cites a decision on the use of probability analysis to determine whether an amount has been "substantially fixed" for purposes of subsection 1259(d)(1). Relevant, however, is *Progressive Corp. v. United States*, 970 F.2d 188 (6th Cir. 1992). That case concerned a corporate taxpayer that bought shares of stock and simultaneously sold call options with respect to the shares.[18] Call options are options enabling the option buyer to buy a stock at a specified price (the strike price) at any time before the option expires. When the taxpayer in *Progressive* sold the call options, they were "in the money," meaning that the strike price was below the market trading price. The spread between the strike and market prices gave the option buyer an opportunity to make an immediate profit by exercising the options at the strike price and

17. The Commissioner also uses the reciprocal of Dr. Bessembinder's percentage, stating that "there was a greater than 85% chance that there would be *zero* variation" in the number of shares to be delivered at settlement. Reply Brief for Commissioner at 32 (emphasis in original).

18. As the Sixth Circuit explained, the corporate taxpayer made two sets of complicated arrangements, *Progressive*, 970 F.2d at 190, but only the Court's treatment of the call options in the second set is relevant to the pending appeal.

selling the stock at the market price (as long as the spread exceeded the purchase price of the options).

In *Progressive* the Commissioner had asked the District Court to decide whether the call options "were so deep-in-the-money" that, from the option seller's standpoint (the taxpayer), each option "was the equivalent of a contractual obligation to sell" because it was "virtually certain that the purchasers of the call options would exercise them" promptly and take their quick profits. *Id.* at 193. That mattered because an immediate sale would reduce the taxpayer's holding period of the stock to zero, *see* 26 U.S.C. § 246(c)(3), a consequence that would deprive it of a claimed inter-corporate dividend exclusion, *see id.* § 246(c)(1)(A). *See Progressive,* 970 F.2d at 189-90. The District Court had not decided whether the spread was so great that exercise of the options was virtually certain, and the Sixth Circuit remanded that issue to the District Court for its determination. *See id.* at 194.

The Sixth Circuit's analysis and disposition is relevant to our case because the District Court was asked to decide how likely it was that the option buyer would immediately exercise its purchase right. Or, to frame the issue in terms of Dr. Bessembinder's analysis, the issue was whether the spread created so high a probability of the option buyer immediately exercising its rights that the option seller's obligation to sell was "virtually certain." *Progressive* differs from our case in two respects. The probability to be determined needed to meet the high standard of "virtual certainty" rather than "substantially fixed," and the probability concerned action to be taken on the basis of a market price at the time the option was written, rather than at a future evaluation date when the amended contract would be settled. Nevertheless, meeting the Sixth Circuit's standard on the date the options were written would require consideration of a probability, *i.e.*, the likelihood that the option buyer would then exercise its rights.

Using probability analysis to decide in the pending appeal the likelihood that a stock will not reach a floor price, thereby affecting tax consequences, is neither explicitly authorized nor prohibited by any relevant statute. And although Congress authorized the issuance of "necessary or appropriate" regulations to implement the constructive sale statute, *see* 26 U.S.C. § 1259(f), and the relevant Senate report contemplated that the Treasury Department would do so, *see* S. Rep. 105-33 at 126 (1997), no such regulations have been issued. Nevertheless, we are persuaded to accept probability analysis in this context.

[7] Tax laws are to be applied with an eye to economic realities. *See, e.g., Frank Lyon Co. v. United States,* 435 U.S. 561, 573, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978) (economic realities of transaction to be considered); *Greene v. United States*, 79 F.3d 1348, 1356 (2d Cir. 1996) (26 U.S.C. § 1256 enacted "to harmonize tax treatment of commodity futures contracts with the economic realities of the marketplace"). Virtually all stock transactions rest on the market's (albeit differing) perceptions of the probabilities of share price movement, both the direction and extent of such movement. Probabilities are an economic reality affecting such transactions, and we see no reason why they should not affect the tax consequences of them. Illustrating the point in a context especially relevant to this appeal is the pricing of stock options. Whether or not all traders of options know it, a major determinant of option prices that are bid and asked every day in options markets is the Black-Scholes formula, the same formula that Dr. Bessembinder used to determine the

probabilities in the pending case. *See* footnote 14, *supra*. So the economic reality pertinent to this case is not only the use of probability analysis in general but the use of the widely accepted Black-Scholes probability formula in particular.

A further consideration guides our resolution of this issue. A taxpayer holding a large bloc of appreciated securities and wishing to diversify his portfolio faces the prospect of a considerable capital gain if he sells his shares. Executing a VPFC provides him with the immediate cash that a sale would produce (but no immediate capital gain in view of Rev. Rul. 2003-7). Because financial institutions are unlikely to set settlement dates much later than execution dates (witness the one- and one-and-a-half-year intervals in the contracts in this case), a taxpayer wishing to obtain his up-front payment without having to settle and incur a large capital gain will want to proceed, as McKelvey did, by executing amended contracts extending his settlement and valuation dates. This device is so alluring that he will be willing to pay substantial sums, in this case $11 million, to obtain the extended dates, and financial institutions, as this case shows, will be willing to extend the dates at an appropriate price.

A taxpayer and his VPFC long party can often be expected to repeat these extensions for the taxpayer's life, knowing that at his death the shares will have a stepped-up basis in the hands of his estate. The up-front payment will have been received without ever incurring the capital gains tax that would have been due had the payment resulted from a sale of the stock. In this case that payment was $194 million, and thus far, no capital gains taxes have been paid. The Internal Revenue Code should not be readily construed to permit that result.

We must acknowledge, however, that using probability analysis to prevent capital gain avoidance in this case does not affect all amended VPFCs but only those amended to become forward contracts where the number of shares to be delivered at settlement is substantially fixed because of a share price significantly below the floor price. Nevertheless, despite the somewhat limited frequency of situations in which amendment of the valuation date of a VPFC will create liability for capital gains taxes, we conclude that probability analysis may be used for such a purpose.

The question remains in this case whether the 85 and 87 percentages of probability are sufficiently high (or the 15 and 13 percentages are sufficiently low) to show that the low share price at execution of each amended contract rendered the amount of shares to be delivered at settlement "substantially fixed." No bright line need be established. The percentages are very high, and the share prices yielding these percentages were so low as to be barely more than half of the floor prices. Dr. Bessembinder's report noted that even in the unlikely event that the share price would slightly exceed the floor price on the amended valuation date of each contract, an increase to $31 a share would decrease the number of shares to be delivered at settlement by less than 50,000 shares, less than 0.8 percent of the approximately 6.5 million total of collateralized shares, hardly a "significant variation." S. Rep. 105-33, at 125-26 (1997). So while the probability that McKelvey would have to deliver the total number of collateralized shares was 85 and 87 percent under the two contracts, the probability that he would have to deliver a number of shares close to the total, which would still be a substantially fixed amount, was even higher.

The taxpayer had the burden to prove the determinations in the Commissioner's

notice of deficiency erroneous, *see* T.C. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115, 54 S.Ct. 8, 78 L.Ed. 212 (1933). The Estate presented no evidence to challenge any of Dr. Bessembinder's data or calculations. On this record, we see no basis to conclude that the amount of shares to be delivered at settlement was not "substantially fixed" on the dates each contract was amended. Constructive sales of the collateral shares therefore resulted.

In rejecting the Commissioner's constructive sale contention, the Tax Court did not reach the issue of whether the amount of shares to be delivered at settlement was "substantially fixed." Instead, Judge Ruwe, at least implicitly, rejected the Commissioner's constructive sale claim because the amended contracts did not require McKelvey "to deliver the same or substantially identical property" as the collateralized shares. 26 U.S.C. § 1259(c)(1)(C). We say "implicitly" because Judge Ruwe did not say that subsection 1259(c)(1)(C) was inapplicable. But he did say that (1) "the extensions [of the valuation dates] did not clarify the uncertainty of which property [McKelvey] would ultimately deliver to settle the contracts," and (2) "[McKelvey] had the discretion to settle the VPFCs using stock with a higher or lower basis than the stock pledged as collateral." T.C. op. at 30, 2017 WL 1402129, at *10. Thus, the Tax Court appears to have rejected the Commissioner's constructive sale claim because the shares to be delivered at settlement did not have to be the same as, or substantially identical to, the shares pledged as collateral.

Somewhat surprisingly, neither party explicitly considers this aspect of the Tax Court's ruling. The Commissioner grounds his constructive sale argument solely on the theory, which we accept, that the *amount* of shares (not the identity of shares) to be delivered at settlement was "substantially fixed" because of the depressed price of Monster stock. The Estate grounds its opposition to a constructive sale on two arguments. First, the Estate contends that "Mr. McKelvey did not enter into new contracts at the time of the extensions," Brief for Estate at 47, leaving the original contracts "open," *id.* We have rejected that argument. Second, the Estate contends that, even if the amended contracts were new contracts, there would not be a constructive sale because the amended contracts "would not constitute forward sales of a substantially fixed *amount* of property under section 1259." Brief for Estate at 48 (emphasis added; capitalization altered). Disputing the Commissioner's probability analysis, the Estate asserts, "[T]he chance that Monster stock would rebound to above the floor price of the VPFCs before the extended expiration was certainly not remote."[19] Brief for Estate at 52. We have rejected that argument. Expanding its second argument, the Estate contends that any fixation of the amount of shares to be delivered was not established by the "terms" of the contracts. Brief for Estate at 48-53. But the contract terms, by focusing on closing prices at settlement and keying the number of deliverable shares to the relation of those prices to the floor and cap prices, necessarily require consideration of what those prices would be.

Perhaps both sides plausibly believe that it is the "substantially fixed price" language of subsection 1259(d)(1) that controls the constructive sale issue. Or they more plausibly believe that the "same or substantially identical property" language

19. If the price of Monster shares had closed above the floor price and McKelvey had settled the contracts before his death, he would have been entitled to an adjustment in light of the previous taxation of constructive sales. *See* 26 U.S.C. § 1259 (a)(2), (e)(1).

of subsection 1259(c)(1)(C) means that the property to be delivered must have the same *value* as the appreciated position. It is clear that McKelvey's option to settle with shares other than the collateralized shares required him to deliver property of equal value. Moreover, the Tax Court's observation that McKelvey could have settled with shares having a different basis than the collateralized Monster stock would affect the amount of capital gain arising from a constructive sale, but not whether a constructive sale occurred. In any event, we decide the constructive sale issue as the parties have presented it and conclude that constructive sales of the collateralized shares occurred.

Conclusion

The decision of the Tax Court is reversed, and the case is remanded for (1) determination, in light of this opinion, of whether the termination of obligations that occurred when the amended contracts were executed resulted in taxable short-term capital gains, and (2) calculation of the amount of long-term capital gains that resulted from the constructive sales of the collateralized shares.

JOSÉ A. CABRANES, Circuit Judge, concurring:

I agree with the Court's conclusion that McKelvey, as issuer of the *nondebt* financial instruments in this case, did not exchange property when he modified his contracts with the banks because he held no property interests under the contracts at the time of modification. I write separately to stress that this conclusion does not affect, by implication or analogy, the existing application of Treasury Regulations section 1.1001-3 to holders and issuers of *debt* instruments. Section 1.1001-3 sets forth principles for determining when the modification of a debt instrument is sufficiently "significant" to constitute a taxable event. These principles, as I understand them, apply to both the holder-obligee and the issuer-obligor of the instrument. *See, e.g.*, Rev. Rul. 2004-37, 2004-1 C.B. 583 (applying the principles of section 1.1001-3 to require the issuer of a recourse note to recognize gain resulting from the modification of the note).

COALITION FOR COMPETITIVE ELECTRICITY, DYNERGY INC., Eastern Generation, LLC, Electric Power Supply Association, NRG Energy, Inc., Roseton Generating LLC, Selkirk Cogen Partners, L.P., Plaintiffs-Appellants,

v.

Audrey ZIBELMAN, in her Official Capacity as Chair of the New York Public Service Commission, Patricia L. Acampora, in her Official Capacity as Commissioner of the New York Public Service Commission, Gregg C. Sayre, in his Official Capacity as Chair of the New York Public Service Commission Diane X. Burman, in her Official Capacity as Commissioner of the New York Public Service Commission, Defendants-Appellees,

Exelon Corp., R.E. Ginna Nuclear Power Plant LLC, Constellation Energy Nuclear Group, LLC, Nine Mile Point Nuclear Station LLC, Intervenor-Defendants-Appellees.

No. 17-2654-cv
August Term 2017

United States Court of Appeals, Second Circuit.

Argued: March 12, 2018

Decided: September 27, 2018

Background: Group of electrical generators and trade groups of electrical genera-