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Memorandum

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subject: Variable purchase contracts and share lending agreements

This memorandum sets forth the legal analysis for a share lending agreement coupled with a sale contract like the one described in Rev. Rul. 2003-7, 2003-1 C. B. 363. It will refer to the sales contract and lending transaction together as the "Transaction." This document should not be used or cited as precedent.

ISSUE

Whether a contract for the sale of stock and a share lending agreement, involving the same parties and pertaining to the same shares, results in a current sale of the shares for federal income tax purposes.

CONCLUSION

A contract for the sale of stock and a share lending agreement, involving the same parties and pertaining to the same shares, results in a current sale of the shares for federal income tax purposes.

FACTS

An individual (Seller) held shares of common stock in Y Corporation, which is publicly traded. Seller's basis in the shares of Y Corporation was $3 per share. On September 15, 2002 (Execution Date), Seller entered into an arm's length sales contract with an unrelated third-party (Purchaser), at which time a share of common stock in Y Corporation had a fair market value of $20. Seller received $1,600 of cash upon execution of the sales contract. In return, Seller promised to deliver to Purchaser on September 15, 2005 (Valuation 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 were less than $20 on the Valuation Date, Purchaser would receive 100 shares of common stock. If the market price of a share were at least $20 and no more than $25 on the Valuation Date, Purchaser would receive a number of shares having a total market value equal to $2,000. If the market price of a share were to exceed $25 on the Valuation Date, Purchaser would receive 80 shares of common stock. In addition, Seller had the right to deliver to Purchaser on the Valuation Date cash equal to the value of the common stock that Seller would otherwise be required to deliver under the formula.

In order to secure Seller's obligations under the sales contract, Seller pledged to Purchaser 100 shares of common stock of Y Corporation on the Execution Date under a pledge agreement as part of the sales contract. This was the maximum number of shares that Seller could be required to deliver under the sales contract. Seller effected this pledge by transferring the shares into a pledge account held by a third-party trustee, who was unrelated to Purchaser. Under the pledge agreement, Seller retained the right to vote the pledged shares and to receive dividends, but the pledge agreement instructed the trustee to enter into a share lending agreement with Purchaser in order to loan the pledged shares to Purchaser or another person at Purchaser's direction.

After the Execution Date, Purchaser executed the share lending agreement with the trustee, borrowed 100 shares from the pledge account, and pursuant to the share lending agreement, sold the shares to a third party. Under the terms of the share lending agreement, the shares delivered to Purchaser were unrestricted shares and had dividend and voting rights attached. Moreover, the share lending agreement gave Seller the right to demand that Purchaser transfer shares identical to the borrowed shares into the pledge account if certain conditions were met.

LAW AND ANALYSIS

Amount Realized – Benefits and Burdens

Under section 1001 of the Internal Revenue Code ("Code"), an amount is realized when there is a sale or other disposition of property. Although section 1001 refers to a "sale or other disposition," that phrase is not defined in the Code.

Over the years, the courts have developed a test for determining whether and when a sale or other disposition of property has occurred. This test focuses on the transfer of the benefits and burdens associated with the ownership of that property. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981). The test is factual in nature and requires us to consider the intention of the parties, ascertained from documents and actions, to shift the rights and obligations of the property from one person to another.

It is not necessary for all rights and obligations to shift in order for a disposition to occur, and the shifting of any particular right or obligation is generally not determinative. Instead, the courts have applied the test by balancing the rights that have shifted against those that have not under the particular circumstances of each case. In addition, the weight given to each right or obligation can vary based on the type of property and the particular circumstances.

In order to apply the test in any given case, we must first identify the various rights and obligations associated with the specific type of property at issue. When applying the test to stock, the court in Hall v. Commissioner, 15 T.C. 195, 200 (1950), aff'd 194 F.2d 538 (9th Cir. 1952), focused on (1) who has the opportunity for gain from an increase in value, (2) who bears the risk of loss from a decrease in value, (3) who has the right to vote the shares, (4) who has the right to receive dividends, and (5) who has the right to dominion or control over the stock, especially the right to sell the stock. Transfer of possession in return for a substantial payment in cash is also important. In Hope v. Commissioner, 55 T.C. 1020 (1971), aff'd 471 F.2d 738 (3d Cir. 1973), cert. denied 414 U.S. 824 (1973), the taxpayer wished to dispose of a large block of corporate stock. Under an arrangement with an investment bank, the taxpayer transferred possession of the stock to the investment bank in return for cash. The investment bank sold a portion of the block to the public and retained the proceeds of that sale as its fee. The remainder of the stock was retained by the bank. The taxpayer also transferred options for the remainder to his brother and two other individuals. These options granted the holders the right to purchase the stock for an amount equal to the amount of cash the bank had paid for them. The options also granted the holders the right to vote for corporate directors. Later, 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 his tax return for the year of the initial transfer, the taxpayer did not include his gain on the sale in income, arguing that the transfer was not a completed sale in that year. Holding that the transaction was a sale of the entire block, the court stated:

> The facts of this case conclusively establish that on [the date of the initial transfer], the petitioner sold … [the] stock to [the 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.

Hope, 55 T.C. at 1029.

With respect to the Transaction, the sales contract, pledge agreement, and share lending agreement related to the same stock of Y Corporation. Seller's obligation to deliver shares on the Valuation Date under the sales contract was completely offset by Purchaser's obligation to return identical shares under the share lending agreement. The sales contract and the share lending agreement acted as opposites and counteracted each other. Accordingly, to determine whether ownership transferred on the Execution Date, we must consider all of these contracts together.

As of the Execution Date and throughout the term of the sales contract, Purchaser had the right to most of the gain from the appreciation of the shares and bore all of the risk of loss. Purchaser had the right to sell, pledge or re-pledge the shares to a third party and, when sold, the shares were completely unencumbered to the third party. Thus, on the Execution Date Seller received full payment in cash for the shares and Purchaser had unfettered use of the shares. As contemplated on the Execution Date, when Purchaser was to take actual possession at a later date, the shares would be unrestricted and freely transferable with voting and dividend rights. Under the pledge agreement, Purchaser had the ability to instruct the trustee to enter into a share lending agreement with Purchaser and loan the pledged shares to Purchaser or another person at Purchaser's direction. Therefore, Purchaser acquired and held nearly all of the benefits and burdens of ownership in the pledged shares on the Execution Date, and the Transaction was a completed sale under section 1001 on that date.

Note that Purchaser need not take actual possession, as long as Purchaser had the ability to control the pledged shares. The subsequent acquisition of actual possession by Purchaser, however, provides additional evidence that the parties intended to transfer dominion and control over the shares in addition to other incidents of ownership.

Revenue Ruling 2003-7

Revenue Ruling 2003-7, 2003-1 C.B. 363, describes a contract similar to the sales contract. In that ruling, a shareholder enters into an agreement with an investment bank to receive a fixed amount of cash and 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. To secure the shareholder's obligations to the investment bank under the agreement, the shareholder pledges the maximum number of shares for which delivery could be required under the agreement and transfers the shares to a third-party as trustee. The third party is unrelated to the purchaser. Under the trust agreement, the shareholder retains the right to vote the pledged shares, to receive dividends from the pledged shares, and to substitute cash or other shares for the pledged shares.

The ruling concludes that a shareholder does not sell or dispose of the stock under section 1001 at the time the agreement is executed. In addition to the shareholder's continuing right to receive dividends and the continuing right to vote the shares, the ruling focuses on the transfer of possession of the shares to an unrelated trustee. As stated in the rationale:

> Also… 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.… Accordingly, the execution of the Agreement did not cause a sale or other disposition of the shares.

The transfer to a trustee unrelated to the investment bank and the ability to reacquire those same shares from the trustee shows that the shareholder, rather than the investment bank, had dominion and control over the shares. This point is critical to the holding of the ruling.

Unlike the transaction described in Rev. Rul. 2003-7, the Transaction described above has two components; one styled as a variable, prepaid forward contract and one styled as a share lending agreement. When considered together, these two components transfer dominion and control to the Purchaser. On the Execution Date, Seller pledged to Purchaser the shares of common stock by transferring the shares in trust to a third-party trustee unrelated to Purchaser. Although unrelated to either party, the trustee fails to qualify as an independent trustee who can prevent Purchaser from exercising control over the shares. Because the pledge agreement entitles Purchaser to borrow all of the pledged shares, Purchaser has control over the shares, including the unconstrained right to do as it wishes with the shares. Moreover, Purchaser exercises this right by transferring full control over the shares, including the voting and dividend rights, to a third party. Purchaser could not have done this had it not acquired ownership of the shares on the Execution Date. Consequently, the Transaction is not analogous to Rev. Rul. 2003-7.

Integration

Some have argued that you should focus on the sales contract by itself and compare the rights and obligations under the sales contract to the transaction described in Rev. Rul. 2003-7, ignoring the instruction to the trustee to enter into a share lending agreement with Purchaser. Doing so, however, would be ignoring the economic realities of the Transaction. As the Supreme Court has stated: “In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding.” Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939), 1939-2 C.B. 208. Thus, we must look to “the objective economic realities of a transaction rather than to the particular form the parties employed.” Commissioner v. Tower, 327 U.S. 280, 291 (1946), 1946-1 C.B. 11.

Some have also argued that there is no authority to integrate the sales contract and the pledge agreement with the share lending agreement. They argue that integration requires a specific statutory or regulatory act, like the integration rules for debt instruments and hedges under section 1.1275-6. Consequently, they argue that we must consider the components of the Transaction separately.

In addition to being specious, these arguments are misdirected because we are not purporting to integrate the agreements. When assessing the economic realities of a transaction, the courts will consider the offsetting nature of related contracts. For example, in Helvering v. LeGierse, 312 U.S. 531 (1941), 1941-1 C.B. 430, an individual entered into two contracts with an insurance company, one styled as a single-premium life insurance contract, the other as a standard annuity contract. The total consideration was prepaid, and it exceeded the face value of the insurance contract. The individual was not required to pass a physical examination or to answer the questions normally required of a life insurance applicant. The Taxpayer conceded that the insurance contract would not have been issued without the annuity contract.

The Supreme Court determined that the two contracts must be considered together and that, together, they failed to spell out any element of insurance risk. It found that the contracts acted as opposites, counteracting each other so that in combination, the risk customarily inherent in an insurance contract was neutralized. The Court did not integrate the two contracts and hold that there was really only a single contract. Instead, it looked to the economic realities and found lacking the risk necessary for insurance. Arguments that the contracts could be assigned or surrendered separately did not distract the Court from focusing on economic realities of the coexisting contracts. As a result, the insurance contract was treated as something other than life insurance.

Like the contracts in LeGierse, the sales contract and the share lending agreement could have been entered into independently. In reality, however, they involved the same parties and the same shares, and were connected by the pledge agreement. Following the Supreme Court's lead, we must consider them together, and together they transfer almost all of the rights and obligations associated with the ownership of the shares of Y Corporation to Purchaser on the Execution Date.

Open Transaction Doctrine

The open transaction doctrine relieves a taxpayer from reporting income that may never be received. This doctrine was derived from the seminal case, Burnet v. Logan, 283 U.S. 404 (1931), X-1 C.B. 345. In Burnet v. Logan, the taxpayer owned stock in a corporation which, in turn, held a leasehold interest in a mine. The taxpayer sold the stock for cash plus an agreement to receive from the purchaser 60 cents per ton on all ore apportioned to the corporation. There was no provision for a maximum or minimum tonnage. Because the taxpayer's capital investment might never be recovered, the contractual promise to pay per ton was too contingent and speculative to determine the value received by the taxpayer. Thus, the Court determined that the annual payments received under the agreement should be apportioned first as return of capital and later as profit.

The open transaction doctrine is only applicable, however, when it is not possible to determine the value of either of the assets exchanged. In an arm's-length transaction, where only one of the assets has an unascertainable value, it is presumed equal to the property for which it was exchanged. In United States v. Davis, 370 U.S. 65 (1962), 1962-2 C.B. 15, the taxpayer transferred appreciated stock to an ex-spouse under an agreement for the settlement of property. The Court disagreed with the argument that, because it was impossible to compute the fair market value of the marital rights at the time of the transfer, gain could not be determined and so it should not be taxed at that time. Instead, the Court presumed that the marital rights were equal in value to the property for which they were exchanged. By citing to the Court of Claims decision in Philadelphia Park Amusement Co. v. U.S., 126 F. Supp. 184, 189, 130 Ct.Cl. 166 (1954), the Court acknowledged that the presumption of equality extends to financial transactions. Davis, 370 U.S. at 72. When an exchange is made at arm's-length and the property for which an obligation is exchanged has a readily ascertainable fair market value, there are no rare and extraordinary circumstances that require the transaction to remain open.

Focusing solely on the sales contract, Seller appears to have transferred an indeterminate amount of Y Corporation stock, so that the fair market value of the property transferred by Seller appears to be indeterminate. However, when the components of the Transaction are considered together, the Seller instead has actually transferred all of the stock on the Execution Date and simultaneously received cash and the right to receive a variable amount of identical stock in the future. Nothing is indeterminate. The stock is publicly traded and has a readily ascertainable fair market value. The amount realized includes the amount of cash received by Seller plus the value of the right to receive a variable amount of identical stock in the future. Gain can be determined easily because the value of the right received by Seller must be equal to the value of the stock transferred on the Execution Date less the amount of cash received. The open transaction doctrine, as established by the courts from Burnet v. Logan, does not apply to Seller's transfer of Y Corporation stock.

Section 1058

Having determined that the Transaction resulted in a disposition, section 1001(c) provides that, except as otherwise provided, the entire amount of the gain or loss on the sale or exchange of property shall be recognized. Section 1058 is one exception to the recognition requirement under section 1001(c). Section 1058 applies to transfers of securities in exchange for a contractual obligation to return identical securities. In this Transaction, Seller has transferred its shares in exchange for cash and other consideration, none of which represents an obligation under an agreement to return identical shares. Seller's ability to acquire shares on the Valuation Date is simply a purchase. Therefore, any argument that section 1058 applies to this Transaction is illusory.

In addition, even if the argument had any substance, the Transaction fails to meet the technical requirements of section 1058. Section 1058 provides for the nonrecognition of gain or loss when taxpayers exchange securities for certain agreements. To qualify for this treatment, an agreement must satisfy four requirements. First, it must provide for the return to the transferor of securities that are identical to the securities transferred. Second, from the date of the transfer to the date of the return, it must require that amounts be paid to the transferor that are equivalent to all interest, dividends, and other distributions that an owner would be entitled to receive. Third, it must not reduce the transferor's risk of loss or opportunity for gain from the securities transferred. Last, it must meet any other requirements prescribed in regulations.

Considering the sales contract, the pledge agreement, and the share lending agreement together, the Transaction is not a typical lending transaction. More importantly, the Transaction reduces Seller's risk of loss in the Y Corporation stock that was transferred to Purchaser. The precise language of section 1058(b)(3) states that the agreement for the return of transferred shares must not reduce the risk of loss to the lender in the transferred shares. It is unreasonable to think that Congress would have intended for taxpayers to avoid this requirement by using a simple device of separating their agreement into two or more documents. Consequently, section 1058 does not apply to the Transaction.

Later Acquired Shares

In the Transaction, Seller transferred all of the stock on the Execution Date and simultaneously received cash and the right to receive an indeterminate amount of identical stock in the future. Seller's basis in that right is equal to the value of all of the stock transferred on the Execution Date less the amount of cash received. Under the facts of the Transaction, this basis is equal to $400 (i.e, the $2,000 value of the shares minus the $1,600 of cash received). If Seller receives shares on the Valuation Date under this right, the Seller will take a basis in those shares equal to its basis in the right (i.e., $400).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

You have informed us that the use of transactions like the one described above has increased since 2000, and that there are a number of variations. For example, in some arrangements, sales contracts give the Seller the right to settle in cash rather than by delivery of stock on the Valuation Date. In other arrangements, the Seller has differing voting rights and dividend rights. We encourage you to develop these cases, and we stand ready to assist you in the legal analysis. We also encourage you to examine any exit strategies that taxpayers may have used to further defer or permanently avoid the recognition of gain under section 1001.

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