Office of Chief Counsel
Internal Revenue Service
memorandum

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date:

to:
(Large and Mid-Size Business)

from: Associate Area Counsel (Large & Mid-Size Business)

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subject:

Advisory Opinion: Taxability of Transaction

Issue:

Whether the transaction at issue gives rise to a currently taxable event under I.R.C. § 1259 and Rev. Rul. 2003-7.

Conclusion :

As discussed below, Rev. Rul 2003-7 is found to apply such that the transaction in issue does not result in a sale in the year of the transaction under I.R.C. § 1259.

FACTS:

On , Company's Board of Directors approved a resolution to monetize shares common stock with a book basis of $ million and tax basis of $ million. According to the minutes, had certain projects that required significant capital expenditures. realized that selling the shares of stock would provide some or all of the necessary capital but also realized that the sale of the shares would result in significant taxable gain. president was directed to execute a
contract). The monetization would not result in a tax

liability on the gain, but would protect against the risk of decline in the market value of the stock while preserving capital growth opportunities and simultaneously providing liquidity from an otherwise illiquid asset, thereby assisting the Corporation in funding its capital requirements.

On , entered into a contract to deliver a number of shares of common stock to in exchange for an upfront cash payment of $ million. The stock had a market value of $ per share on the closing date of the contract. The difference between the market value and the upfront payment represents the costs of entering into the contract (transactional costs and financing costs). The contract, called a Contract, provides that receive the cash payment on and deliver the stock on (the Maturity Date). During the seven-year term of the secured forward exchange contract, retains ownership of the stock. Accordingly, granted a security interest in Pledged Items as defined in the Pledge Agreement.

On the maturity date, must deliver either the shares of common stock or cash in settlement of the contract (Section). If does not deliver the stock or cash by on the maturity date, the collateral will be considered Free Stock and will be delivered from the Collateral Account in settlement of the contract.

Up to and including the maturity date, is required to make quarterly contract payments based on the average Aggregate Contract Price (Section); however, exercised its option to prepay the contract payments (Section). As of , prepaid contract payments totaled $. As a result of the prepayment, is not required to make any further contract payments. These contract payments compensate the investor for bearing all the stock’s downside risk and for participating in only limited upside potential.

On , assigned and pledged to (1) the initial pledged items, (2) all additions to and substitutions for the pledged items and (3) all income, proceeds and collections received or to be received from or in connection with the initial

pledge items or the addition and substitutions (Section 1(a) of the pledge agreement).

The pledge agreement requires to deliver the initial pledged items to the custodian by the closing date. The pledge agreement defines initial pledged items as the Eligible Collateral equal to the quotient of (1) the Base Amount as of the Closing Date divided by (2) the Conversion Rate as of the Closing Date. The base amount (shares) was delivered to the custodian on (Section). Eligible collateral is defined as Common Stock or Preferred Stock (share collateral) or government securities where has elected to substitute government securities for share collateral.

may also pledge additional eligible collateral consisting of common stock or preferred stock at any time (Section of the pledge agreement). may substitute Government Securities for all (but not less than all) of the Collateral consisting of the Common Stock or Preferred Stock held in the collateral account as long as no acceleration event has occurred (Section of the pledge agreement).

Embedded Collar- The contract serves as a hedge against the decline in the stock value and allows to participate in the increase in stock value by placing a cap and a floor on the number of shares to be delivered. The contract requires

to deliver no less than shares and no more than shares. The number of shares to be delivered under the contract is the product of

(Base Amount)

multiplied by an Exchange Rate (Section

). The price of

stock at inception of the contract was $. If were to deliver the shares on the contract inception date, the total number of shares to be delivered is (

) or $.

CAP

On the maturity date, if the market price is equal to or

less than $, the exchange rate is set at 1 and will deliver the entire (x 1) shares. For example, if the market price is $, would normally have to deliver

shares or $ to settle the contract; however, since the number of shares has been capped, will only deliver shares at $ /share or $. risk on the decline in value of stock has been eliminated.

On the maturity date, if the market price is between $ and $, will deliver more than but less than shares. For example, if the maturity price is $, will deliver (x) shares or $

. would normally deliver shares at $ /share or $ - a price which reflects a % increase in value of the shares over $; however, since only a fraction of the shares is required to be delivered, retains the increase in value of the stock up to % ($).

FLOOR

On the maturity date, if the market price is greater than $, the exchange rate is set at . and will deliver only (x) shares. For example, if the maturity price is $, will deliver the shares or $

(shares at $ /share). would normally have to deliver $ (at $ /share) if it had to cash settle the entire shares. retains the first % increase in value of the stock and approximately % of any appreciation in excess of %.

For book purposes, classified the transaction as a secured forward exchange contract. No gain or loss on the transaction was reported. Prepaid interest and transaction costs were amortized over the term of the contract.

For tax purposes, classified the transaction as a prepaid executory contract for the delivery on a future date of a number of shares of stock that varies significantly depending on the value of such shares on the delivery date (or the cash equivalent value of such variable number of shares).

The terms of the forward contract provided for annual contract payments to be made by to beginning on , subject to right to prepay these contract payments, in whole or in part. exercised this right and prepaid the contract payments in full in . These contract payments are not interest for Federal income tax purposes because the forward contract is not debt with respect to the characterization of the forward contract. Moreover, did not deduct any portion of its prepayment of the contract payments pursuant to I.R.C. § 263(g). See Treas. Reg. § 1.263(g)-3(b)(3) (requiring capitalization of "otherwise deductible payments or accruals on financial instruments that are part of a straddle").

will recognize gain or loss upon the delivery of cash or stock at the end of the term of the forward contract, in an amount equal to the difference between (A) the amount realized by from the forward contract and (B) if settles the forward contract (i) in cash, the amount of cash paid by or (ii) with shares of Common Stock (which should be shares that

currently owns or shares that subsequently acquires), adjusted tax basis in such shares.

The Pledge Agreement governs and rights and obligations with respect to the collateral account. Pursuant to the Pledge Agreement, generally retains control over the shares in the collateral account and is entitled to substitute as collateral other shares of stock or Treasury securities. is also entitled to vote the pledged shares and is entitled to any dividends that are paid on such shares (although such dividends generally would become part of the collateral). was given a perfected interest in the collateral.

The Pledge Agreement provides with the right to cause any or all of the stock that is pledged as collateral to be transferred of record into the name of the custodian (i.e. the), or its nominee. Thus, as a technical matter, it is possible that any of these parties or could receive cash dividends that are paid on stock that is held in the collateral account. Regardless of which party actually receives any such dividends, Section of the Pledge Agreement provides that

shall have the right to receive and retain as Collateral (as defined in the

Pledge Agreement)" all proceeds of the Collateral (excluding Ordinary Cash Dividends [as defined in the contract] but including, without limitation, Extraordinary Cash Dividends [as defined in the contract] or interest)…" However, Section of the contract provides for appropriate adjustments to be made in determining the number of shares of stock (if elects to settle the contract in shares), or the amount of cash (if elects to settle the contract in cash), to be delivered by upon termination of the contract to account for any Extraordinary Cash Dividends (as defined in the contract) that are paid with respect to the stock to the extent that such dividends would have the effect of diluting the value of the stock.

Discussion:

I.R.C. § 1259, the key provision for the analysis of this transaction, provides for the following:

> (a) IN GENERAL.—If there is a constructive sale of an appreciated financial position—
>
> (1) 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 (and any gain shall be taken into account for the taxable year which includes such date), and
>
> (2) for purposes of applying this title for periods after the constructive sale—
>
> (A) proper adjustment shall be made in the amount of any gain or loss subsequently realized with respect to such position for any gain taken into account by reason of paragraph (1), and
>
> (B) the holding period of such position shall be determined as if such position were originally acquired on the date of such constructive sale.
>
> (b) APPRECIATED FINANCIAL POSITION.—For purposes of this section—
>
> (1) IN GENERAL.—Except as provided in

paragraph (2), 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.

(2) EXCEPTIONS.—The term "appreciated financial position" shall not include—

(A) any position with respect to debt if—

(i) the position unconditionally entitles the holder to receive a specified principal amount,

(ii) the interest payments (or other similar amounts) with respect to such position meet the requirements of clause (i) of section 860G(a)(1)(B), and

(iii) such position is not convertible (directly or indirectly) into stock of the issuer or any related person,

(B) any hedge with respect to a position described in subparagraph (A), and

(C) any position which is marked to market under any provision of this title or the regulations thereunder.

(3) POSITION.—The term "position" means an interest, including a futures or forward contract, short sale, or option.

(c) CONSTRUCTIVE SALE.—For purposes of this section—

(1) IN GENERAL.—A taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person)—

(A) enters into a short sale of the same or substantially identical property,

> (B) enters into an offsetting notional principal contract with respect to the same or substantially identical property,
>
> (C) enters into a futures or forward contract to deliver the same or substantially identical property,
>
> (D) in the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) with respect to any property, acquires the same or substantially identical property, or
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> (E) to the extent prescribed by the Secretary in regulations, enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

A review of the Committee report concerning these provisions is important as the report is a point of discussion. The Committee Reports on P.L. 105-206 (IRS Restructuring and Reform Act of 1998) provides as follows:

> Treasury guidance. -- The bill provides regulatory authority to the Treasury to treat as constructive sales certain transactions that have substantially the same effect as those specified (i.e., short sales, offsetting notional principal contracts and futures or forward contracts to deliver the same or substantially similar property).
>
> It is anticipated that the Treasury will use the provision's authority to treat as constructive sales other financial transactions that, like those specified in the provision, 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. Because this standard requires reduction of both risk of loss and opportunity for gain, it is intended that transactions that reduce only risk of loss or only opportunity for gain will not be covered. Thus, for example, it is not intended that

a taxpayer who holds an appreciated financial position in stock will be treated as having made a constructive sale when the taxpayer enters into a put option with an exercise price equal to the current market price (an "at the money" option). Because such an option reduces only the taxpayer's risk of loss, and not its opportunity for gain, the above standard would not be met.

For purposes of the provision, it is not intended that risk of loss and opportunity for gain be considered separately. Thus, if a transaction has the effect of eliminating a portion of the taxpayer's risk of loss and a portion of the taxpayer's opportunity for gain with respect to an appreciated financial position which, taken together, are substantially all of the taxpayer's risk of loss and opportunity for gain, it is intended that Treasury regulations will treat this transaction as a constructive sale of the position.

It is anticipated that the Treasury regulations, when issued, will provide specific standards for determining whether several common transactions will be treated as constructive sales. One such transaction is a "collar." In a collar, a taxpayer commits to an option requiring him to sell a financial position at a fixed price (the "call strike price") and has the right to have his position purchased at a lower fixed price (the "put strike price"). For example, a shareholder may enter into a collar for a stock currently trading at $100 with a put strike price of $95 and a call strike price of $110. The effect of the transaction is that the seller has transferred the rights to all gain above the $110 call strike price and all loss below the $95 put strike price; the seller has retained all risk of loss and opportunity for gain in the range price between $95 and $110. A collar can be a single contract or can be effected by using a combination of put and call options.

In order to determine whether collars have substantially the same effect as the transactions specified in the provision, it is anticipated that Treasury regulations will provide specific standards that take into account various factors with respect to the appreciated financial position, including its

> volatility. Similarly, it is expected that several aspects of the collar transaction will be relevant, including the spread between the put and call prices, the period of the transaction, and the extent to which the taxpayer retains the right to periodic payments on the appreciated financial position (e.g., the dividends on collared stock). The Committee expects that the Treasury regulations with respect to collars will be applied prospectively, except in cases to prevent abuse.

The Service has issued Rev. Rul. 2003-7, 2003-5 C.B. 363, that deals with a situation which is substantially similar to that in the instant case. In this ruling a taxpayer entered into a variable prepaid forward contract with an investment bank. The contract required the shares to be delivered in three years to the investment bank. The contract had an embedded collar with a 25% spread between put and call prices. The shares had a market value of $20 on the execution date. On the exchange date, if the market price of the stock is less than $20, the investment bank would receive 100 shares. If the market price is at least $20 and no more than $25 on the exchange date, the investment bank will receive shares having a total market value equal to $2,000. If the market price exceeds $25 on the exchange date, the investment bank will receive 80 shares of common stock. The taxpayer had the option to deliver cash equal to the value of the stock required to be delivered on the exchange date.

This ruling concluded that no sale occurred because the shareholder entered into an arm’s length transaction to deliver a number of variable shares (as opposed to a fixed number of shares) on a future date and the shareholder was not economically compelled to transfer the shares because the shareholder had an unrestricted legal right to substitute cash or other shares of stock. This ruling relies heavily upon I.R.C. § 1259(c)(1)(C) in determining whether a sale took place. The constructive sale provision was determined to be inapplicable because of the variable number of shares required to be delivered; however, the ruling does not address whether the contract could qualify as a constructive sale under I.R.C. § 1259(c)(1)(E).

The factual pattern here parallels Rev. Rul. 2003-7, except that we have a % spread between put and call (the ruling posits a 25% spread) and delivery here is years (the ruling posits three years). Because of the similarity of the facts in the instant case, and those of the ruling, we referred this

matter to the National Office branch that produced Rev. Rul. 2003-7.

Rev. Rul. 2003-7 does not address whether the contract could qualify as a constructive sale under I.R.C. § 1259(c)(1)(E). I.R.C. § 1259 provides that a taxpayer is deemed to have a constructive sale of an "Appreciated Financial Position" when the taxpayer enters into a forward or futures contract to deliver the same or substantially identical property. The stock meets the definition of appreciated financial position under I.R.C. § 1259(b)(1). We considered the argument that because had also entered into a forward contract for future delivery of the shares of stock, a constructive sale had occurred. I.R.C. § 1259(d)(1) defines the term "forward contract" 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 contract providing for delivery of an amount of property, such as shares of stock that are subject to significant variation under the contract terms does not result in a constructive sale; however, no definition of "significant variation" has been provided.

Based on the National Office's position, we cannot perceive that we can avoid the imposition of the results of Rev. Rul. 2003-7 on our transaction leaving us without a constructive sale under I.R.C. § 1259.

This, of course, does not preclude a potential factual determination that an actual sale occurred. To determine if an actual sale occurred we look to determine whether the benefits and burdens of ownership have shifted and in this regard we can look to the factors typically relied upon and as set-out in PLR 200111011. However, in order to argue an actual sale occurred under a benefits and burdens analysis, we must distinguish Rev. Rul. 2003-7 as we cannot argue against our own revenue ruling, regardless of the position taken in FSA 200111011. I do not believe that, in this case, the variation in maturity dates is significant enough to warrant a different result. The question, therefore, is whether there are other facts that may distinguish this case from the facts set forth in Rev. Rul. 2003-7.

As set-out in PLR 2001110011, in determining whether the benefits and burdens of ownership have shifted, courts have considered various factors. These factors include: (1) whether the sale price was fixed; (2) whether a significant amount of the agreed price has been paid; (3) the descriptive terms used in the agreement; (4) whether an effective date has been agreed upon fixing a specific time for recognition of the rights and obligations of the parties; (5) whether the purchaser bears the risk of loss and opportunity for gain; (6) whether legal title has passed; (7) the intention of the parties; and (8) the probability that the transaction would be consummated. See Clodfelter v. Commissioner, 48 T.C. 694 (1967), aff'd, 426 F.2d 1391 (9th Cir. 1970); Maher v. Commissioner, 55 T.C. 441 (1970), aff'd in part and remanded in part 469 F.2d 225 (8th Cir. 1972), nonacq. 1977-2 C.B. 2. Not all of these factors must be present for the transaction to be treated as a sale. Maher, 55 T.C. at 452.

We have coordinated these issues with both the National Office as well as the Industry Counsel, Financial Products, and they concur it the opinions expressed herein.

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